

# How Would Reforming the Mortgage Interest Deduction Affect the Housing Market?

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Opponents of mortgage interest deduction, or MID, reform warn that reducing it would undermine the value of owner-occupied homes and hurt the economy by impeding the recovery of the depressed housing market. The best available evidence predicts far less dire effects, and some reforms to the MID could actually bolster the housing market recovery. However, the results are far from definitive.

The mortgage interest deduction is one of the oldest and largest tax expenditures in the federal income tax. In 2012, it cost the federal treasury an estimated \$70 billion, more than all appropriations and outlays for rental housing (\$62 billion).<sup>1</sup> The MID was not originally placed in the federal tax code to subsidize homeownership. When the modern federal income tax was enacted, all interest payments were made deductible on the grounds that interest payments were an expense of earning business and investment income. The deduction had little effect on housing investment before World War II because only the very highest income individuals paid any income tax. The extension of the income tax to middle-class families and the increase in homeownership that accompanied the post-World War II economic boom, however, turned the MID into a major subsidy for middle- and upper-middle-income homeowners. For decades, it has enjoyed broad political support, often characterized as a critical support for the American Dream of homeownership.

In early 2013, amid intense political debate about federal deficits, taxes, and entitlement spending, the Bipartisan Policy Center Housing Commission issued a pack-

age of housing policy recommendations that raised the issue of reforming of the mortgage interest deduction.

Those opposing reforms to the MID often warn that reducing it would undermine the value of owner-occupied homes—the single biggest asset for most American households—and hurt the economy by impeding the recovery of the depressed housing market. But the best available evidence predicts far less dire effects and suggests that some reforms to the MID could actually bolster the housing market recovery. However, only limited research has systematically explored the full range of market effects, and the results are far from definitive. To explore this knowledge gap, the Urban Institute hosted a roundtable of housing researchers and policy experts from academia, government, and industry to discuss and debate the theory and empirical evidence regarding MID reform's effects on the housing market, and to set a course for future research.

## Who Benefits from the MID?

Most roundtable participants readily affirmed that the MID as currently structured does not further the goal of increasing homeownership among the middle class, but instead rewards

**The commission supports the continuation of tax incentives for homeownership, but as part of the ongoing debate over tax reform and budget priorities, the commission also recommends consideration of modifications to these incentives to allow for increased support for affordable rental housing...** The

federal government currently provides substantial resources in support of housing, the majority of which is in the form of tax subsidies for homeownership.... In the ongoing debate over tax reform and budget priorities, all revenue options must be evaluated. In that context, the commission recommends consideration of further modifications to federal tax incentives for homeownership to allow for an increase in the level of support provided to affordable rental housing. Any changes should be made with careful attention to their effects on home prices and should be phased in to minimize any potential disruption to the housing market.

**FROM THE BIPARTISAN POLICY CENTER HOUSING COMMISSION'S RECOMMENDATIONS**

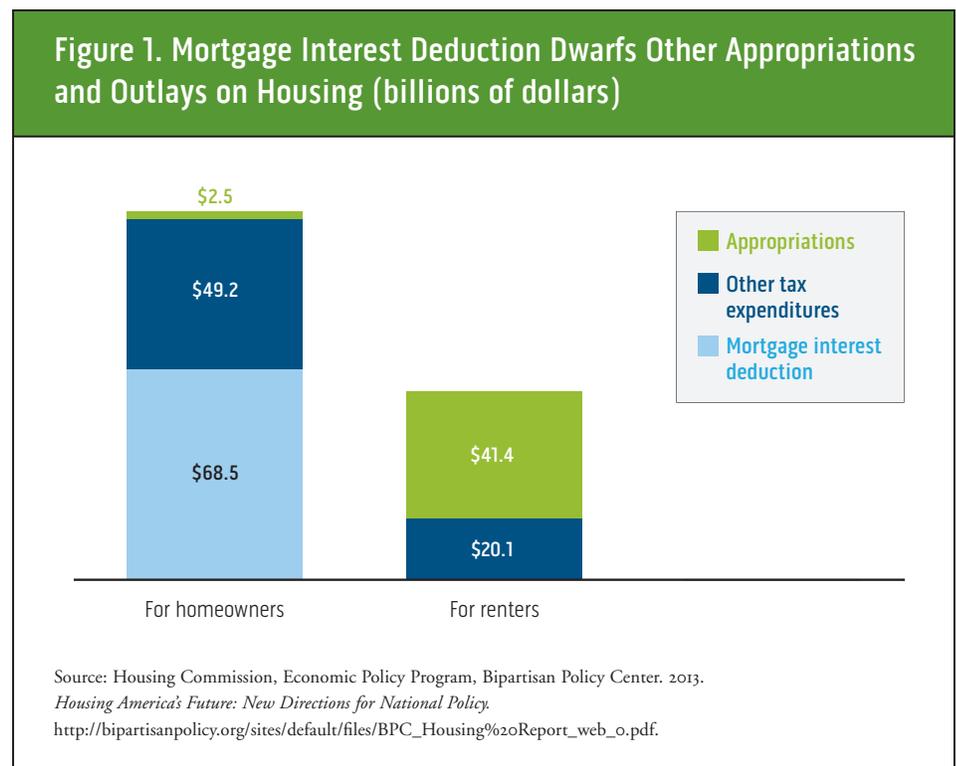
affluent households who would have bought homes anyway. The MID gives these homeowners incentives to buy more expensive homes, take out larger mortgages, and buy vacation homes (whose mortgage interest is also deductible). A recent Zillow.com survey of over 100 economists, real estate experts, and housing market investors and strategists found that only about 1 in 10 support the MID in its current form, with the majority favoring either eliminating it or phasing it out gradually.<sup>2</sup> Some have also suggested replacing the deduction with a refundable credit for interest or for first-time home purchases, which would extend the subsidy to low- and middle-income households considering a home purchase.

The Urban–Brookings Tax Policy Center has estimated how possible MID reform options would affect people’s tax liabilities in tax year 2022. Reforms that either eliminate or scale back the deduction would have the largest impact on upper-middle-income taxpayers, because they are the most likely to itemize their deductions, pay high marginal tax rates, and own expensive homes with big mortgages.<sup>3</sup> Replacing the deduction with a refundable tax credit would partially offset the tax increases on higher-income households and reduce tax liabilities for more moderate-income homebuyers.

### Does the MID Raise Housing Prices?

Evidence about how MID reforms might affect housing prices is far less definitive. In theory, by reducing the user cost of capital (the annual cost to the homeowner per dollar of housing value), the MID should enable people to afford to pay higher prices for houses. With a fixed stock of housing in the short run, this higher demand price should translate into higher sales prices.

One widely cited 1996 study by Dennis Capozza, Richard Green, and Patric Hendershott estimated that eliminating the mortgage



interest and property tax deductions would reduce housing prices in the short term by an average of 13 percent nationwide, with regional changes ranging from 8 to 27 percent.<sup>4</sup> Using a similar approach, Benjamin Harris estimated that eliminating the mortgage interest deduction alone would lead to a 28 percent decline in metropolitan-area housing prices in cities where the average taxpayer buying a new house is in the 35 percent tax bracket. This decline would be less severe in cities with less-affluent residents.<sup>5</sup> Both studies find that price declines would be largest in cities with low rent-to-price ratios and high property tax rates.

When a similar analysis was done using data from 2006 to 2010, however, the results were much less clear, showing no discernible relationship between the MID and house prices.<sup>6</sup> The participants at our roundtable agreed that this means post-recession housing market conditions have disrupted the normal

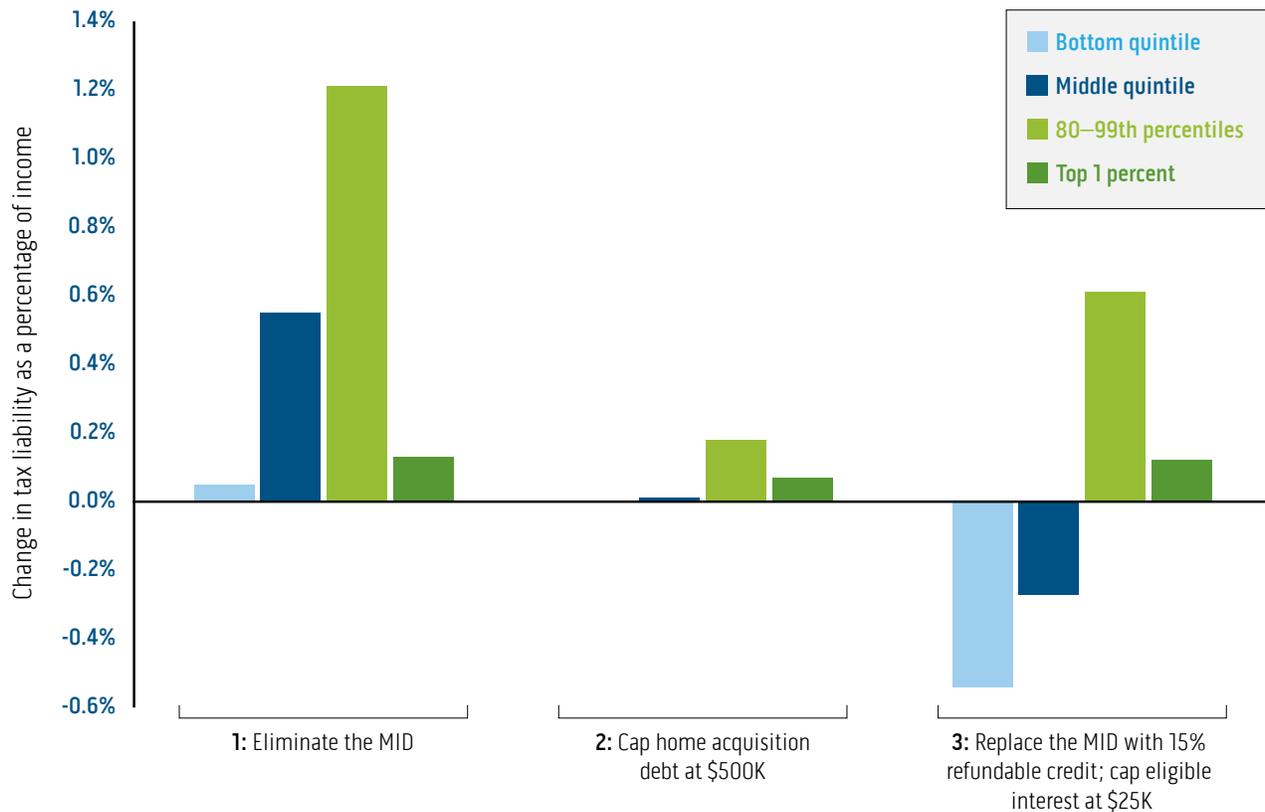
relationships between user costs, rents, and house prices—not that the MID no longer affects house prices. The current turbulence in housing markets simply makes it extremely difficult to predict the effects of changes in the MID.

### Would MID Reform Weaken Housing Markets?

Despite these inconclusive results, a careful look at current housing market conditions reveals several factors that would likely dampen the marketwide effects of MID reform:

- Mortgage interest rates are currently so low that the value of the MID is small by historic standards.
- Rents are currently high relative to house prices, increasing demand from investor-owners that might substitute for any decline in demand from homeowners.

Figure 2. Reforms to the MID Would Increase Taxes for Higher-Income Taxpayers



Source: Urban-Brookings Tax Policy Center simulations.

- Affluent homeowners with high wealth could pay off a portion of their mortgage debts, thereby reducing their interest costs, to compensate for a cut in the MID, rather than reducing their demand for housing.
- Because the stock of owner-occupied housing would gradually adjust in response to changes in tax policy, eliminating the MID may have little effect on housing prices over the longer term.<sup>7</sup>

Moreover, many MID reform proposals would not simply eliminate the deduction, but restructure it in ways that primarily affect the highest-income homeowners or just those with the biggest mortgages. For example, a Zillow.com study estimates that a \$25,000 MID cap would have its biggest impacts in ZIP codes with mean home values over \$850,000.<sup>8</sup> Other proposals that shift the MID to benefit low- and moderate-income buyers could actually stabilize and increase prices of lower-priced homes, whose values continue to lag.

### What More Can We Learn?

As debate over possible reform to the mortgage interest deduction continues, the Urban Institute plans a program of independent research to further explore behavioral and market changes, strengthening the evidence upon which policymakers can rely. In particular, the Institute plans to

- further explore the extent to which high-wealth homeowners would shift their asset holdings and pay down mortgage debt, using the Survey of Consumer Finances; and

- estimate the extent to which high rents encourage the conversion of homes from homeownership to rental occupancy, using the American Housing Survey.

These investigations will help policymakers better gauge how changes to the MID would affect housing demand and house prices in the near term.

In order to explore longer-term market responses to MID reform, work is under way to develop a model for simulating the workings of housing markets; the model will reflect demand for different types of housing from households across the income spectrum as well as from investors, along with changes in housing supply that result from these changes in demand. Such a simulation model would also take account of the effects of other federal programs, including guarantees by Fannie Mae and Freddie Mac, FHA-insured lending, and financial regulations. It could be used to help explore questions about the effects of broader housing finance reforms, such as changes in the availability and cost of mortgages, underwriting standards, and down payment requirements. ■

#### ROUNDTABLE PARTICIPANTS

Arthur Acoca	Wharton School, University of Pennsylvania
Bob Avery	Federal Housing Finance Agency
Adam Cole	U.S. Treasury Department
Cristian deRitis	Moody's Economy.com
Robert Dietz	National Association of Home Builders
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Robert Dunsky	Federal Housing Finance Agency
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Richard Green	USC Price School
Peter Hamp	Brookings Institution
Brian Highsmith	National Economic Council
Stan Humphries	Zillow Real Estate Research
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Eric Toder	Urban Institute
Margery Austin Turner	Urban Institute
Kamila Sommer	Federal Reserve Board
Susan Wachter	Wharton School, University of Pennsylvania
Carol Wayman	Senior Legislative Assistant, Congressman Keith Ellison (MN-05)
John Weicher	Hudson Institute
Mark Willis	NYU Furman Center for Real Estate and Urban Policy

## Notes

1. Tax expenditures for owner-occupants include deductions for property taxes on real property, the exclusion of capital gains on the first \$500,000 per couple of sales of principal residences, and other tax expenditures. Tax expenditures for rental housing include the Low Income Housing Tax Credit (not a preference for housing specifically) and the depreciation of rental housing in excess of an alternative depreciation system. Appropriations for rental housing include tenant- and project-based rental assistance and public housing. Tax expenditure numbers from the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012–2017* (Washington, DC: U.S. Government Printing Office, 2013). Appropriations numbers from Maggie McCarty and David Randall Peterman, *Transportation, Housing and Urban Development, and Related Agencies (THUD): FY2013 Appropriations* (Washington, DC: Congressional Research Services, 2012). Reported in Bipartisan Policy Commission, *Housing America's Future: New Directions for National Policy*, February 2013.
2. Zillow.com. 2012. Zillow Home Price Expectations Survey, September 2012.
3. Lower-income households either rent or do not itemize their deductions, and the very highest income households can self-finance their homes by paying down other assets and are not so reliant on the mortgage interest deduction.
4. Dennis R. Capozza, Richard K. Green, and Patric H. Hendershott, "Taxes, Mortgage Borrowing, and Residential Land Prices," in *Economic Effects of Fundamental Tax Reform*, edited by Henry J. Aaron and William G. Gale (Washington, DC: Brookings Institution Press, 1996, 171–98).
5. Benjamin H. Harris, "Empirical Essays on Taxation and Tax Policy," PhD dissertation, The George Washington University (Publication No. UMI 3449147).
6. These analyses apply a user cost of capital model, which predicts that as the value of the MID decreases and the after-tax cost of mortgage borrowing rises, the price people want to pay for owner-occupied housing should fall. With housing rents set by the demand for housing services and the current housing stock, the model assumes that differences in the ratio of rents to prices among metropolitan areas should reflect differences in the user cost of housing capital. Eliminating the MID would raise the user cost, which in turn would raise the rent-price ratio and (with rents fixed in the short run) lower the price of housing.
7. Douglas Holtz-Eakin, "Comment," in *Economic Effects of Fundamental Tax Reform*, edited by Henry J. Aaron and William G. Gale (Washington, DC: Brookings Institution Press, 1996, 198–210).
8. Clark Lundberg, "How a \$25,000 Itemized Deduction Cap Would Affect Homeowners," Zillow.com, November 5, 2012, <http://www.zillowblog.com/research/2012/11/05/how-a-25000-itemized-deduction-cap-would-affect-homeowners/>.

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