Mortgage Interest Deductibility and Housing Prices
by Stephen G. Cecchetti and Peter Rupert

Over the past few years, there have been several proposals for replacing the income tax system with a system based on taxing consumption. Many of the proposed reforms include eliminating the deductibility of home-mortgage interest, but this provision raises a question: Since the deduction subsidizes home ownership, will eliminating it substantially reduce the value of owner-occupied housing?

If Congress planned to end the home-mortgage interest deduction, leaving the rest of the tax code untouched, this concern would be well founded. To see why, consider that the decision to buy a house is based on the monthly cost of ownership. Individuals calculate an implicit rental equivalence that combines after-tax mortgage payments, property taxes, insurance, maintenance, and the opportunity cost of their down payment.2 For a given maintenance, and the opportunity cost payments, property taxes, insurance, and the rest of the tax code untouched, the concern would be well founded.

An analysis of how implementing a flat tax on income and ending the deductibility of mortgage interest payments would affect housing prices. The authors show that, to the extent prices decline, higher-income households would bear most of the impact, but increases in the value of their other assets might mitigate the drop in the price of their homes.

In this Economic Commentary, we analyze how implementing a flat tax on income and ending the deductibility of mortgage interest payments would affect housing prices. We argue that, to the extent that housing prices decline, more of the impact will be borne by those at higher income levels. However, since these households put a smaller fraction of their wealth in housing than do lower-income families, changes in the value of their other assets may mitigate the decline in the price of their homes.

Flat Taxes, Interest Rates, and Housing Prices
In its extreme form, the flat tax acts as a pure consumption tax, and, in nearly all of the proposed plans, replaces the current system with one that has a single standard deduction. Each individual’s wage income, less that deduction, is taxed at a flat rate. In addition, firms pay a tax at the same rate on fringe benefits and other nonwage compensation. There are several ways to implement such a consumption tax, but the bottom line is that under a flat tax system, businesses are taxed on their profits and net interest paid, while individuals pay a flat wage tax.

We have said that removal of the mortgage interest rate deduction alone will lead to a decline in housing prices. The size of this decline depends on the homeowner’s marginal tax bracket. It is easy to estimate the loss to homeowners that would result from a partial equilibrium change in the tax code. Suppose we look at an individual who has a 28 percent marginal income tax rate, a $100,000 house, and an $80,000 outstanding mortgage at 8 percent interest with 15 years remaining to be paid. Assuming that he itemi-
izes, the $6,400 interest deduction is worth $1,792. The sum of the savings over the remaining years of the loan, discounted to its present value, is about $12,000, or 12 percent of the house’s value. That is, the immediate elimination of the tax preference for owner-occupied housing would create a 12 percent capital loss for such a person. A recent report by Data Resources International conjectures that housing prices would decline by roughly 10 to 15 percent of the current value of the housing stock, or as much as $1.7 trillion.4

These calculations, however, are based on a constant interest rate. Under the various flat tax plans, many forces might act to change the new equilibrium interest rate. Although there will be no mortgage interest deduction, neither will there be taxes on interest or capital income. There is a direct effect that would push the interest rate down toward that of tax-free investments, which is roughly one to two percentage points lower than the return from taxable investments. Interest rate changes of this magnitude are not uncommon, as figure 1 shows. The impact of the change on after-tax mortgage rates is roughly comparable to the increase we saw between the low in 1993 and the peak in 1994.

Again, however, the world is not so simple, and other effects must be considered. Insofar as capital is mobile worldwide, the interest rate will not fall (or not nearly as much as the two percentage points implied here), since a small change in the tax structure may not change the prevailing world interest rate. Second, altering the tax code almost certainly will bring with it a shift in the type of investments—from the housing sector to the business sector. To the extent that this stimulates growth in the economy, interest rates would rise.5

There are additional forces at work, however, that suggest interest rates may fall—an intertemporal price effect and a wealth effect. Changing to a flat tax system would mean taxing future consumption only once (compared to income taxes, which tax it more than once), leading to a decline in the price of future consumption and a consequent increase in aggregate saving.6 However, this effect would be somewhat mitigated, since much saving (for example, pensions, IRAs, 401(k)s, and unrealized capital gains) are currently not taxed. In addition, to the extent that housing prices do decline, a wealth effect would transfer resources from older to younger generations—because the young could now purchase housing at a lower price. This effect would also lead to an increase in aggregate saving, since younger people save more than older ones. Both of these forces act to decrease interest rates, when all other things are held constant.7

If interest rates did fall on net, individuals could refinance their current homes, which would help offset the loss in value caused by the decline in housing prices. Also, as the return to other investments falls, housing becomes a more attractive investment, further mitigating the drop in housing prices.

As a point of comparison, figure 2 indicates that 15 percent changes in housing prices, both up and down, are not so uncommon.8 Although such a decline in the value of the housing asset reduces wealth, that is not the end of the story; other asset prices will rise, at least partially offsetting this effect.

Moreover, normal swings in the housing market are likely to swamp the effects of tax code changes. As figures 1 and 2 show, when marginal tax rates were decreased in the early and mid-1980s, reducing the benefit of the mortgage interest deduction, housing prices actually rose. The opposite occurred in the early 1990s. Therefore, to the extent that housing prices declined due to the removal of the mortgage interest deduction alone, these effects could be partially offset (if not outweighed) for the reasons we have listed.

Who Benefits from the Mortgage Interest Deduction?

Suppose that, despite these mitigating factors, housing prices still drop when the mortgage interest deduction is removed. In that case, the decline in prices, as well as its effect on household wealth, is likely to vary among families at different income and wealth levels.

The first column of table 1 shows that the percent of U.S. families owning a primary residence rises sharply with income. Roughly 85 percent of families making more than $50,000 a year own their homes, while far less than
wealth at low income levels is in the

to the
gage interest deduction, looks similar
holds that take advantage of the mort-
tions, while at very high income lev-
returns itemize, arranged according
column of table 2 shows the fraction of
itemize its tax returns. The
Obviously, to benefit from the mort-
gage interest deduction, a family must
itemize its tax returns. The first col-
ment of table 2 shows the fraction of
returns itemized, arranged according
to income group. At low income lev-
els, very few returns itemize deduc-
tions, while at very high income lev-
els, nearly all do. The second column,
which shows the fraction of house-
holds that take advantage of the mort-
gage interest deduction, looks similar
to the first. So, even though most of
the wealth at low income levels is in the

50 percent of families earning under
$25,000 do. However, as column 2
shows, homes represent a much larger
fraction of family wealth at low income
levels, reaching 90 percent at very low
incomes. At the other end of the spec-
trum, families whose incomes exceed
$100,000 have less than 20 percent
of their wealth in their primary residence.

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itemize its tax returns. The first col-
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which shows the fraction of house-
holds that take advantage of the mort-
gage interest deduction, looks similar
to the first. So, even though most of
the wealth at low income levels is in the

form of housing, the mortgage interest
deduction is scarcely used.

The third column shows taxpayers’
savings due to the mortgage interest
rate deduction, by income group. This
number represents the amount of tax
revenue lost because of the deduction.
The last column reports what percentage
of the taxpayers’ total savings can be
attributed to each group, and dem-
strates that most of the gains accrue
to those in higher income brackets.

One conclusion that can be drawn from
tables 1 and 2 is that the mortgage
interest deduction is regressive, that
is, more of the benefits are derived by
higher income groups. As a result, end-
ing the deductibility of mortgage inter-
est would have different impacts on
different segments of the population.
Wealthier people tend to own larger
homes and, to the extent that home

prices adjust, the more expensive ones
would change more.

Finally, while analysts have recently
focused on the impact these changes
will have on the market for buying
homes, it is important to note that rent-
ers will also be affected. Since renting is
a substitute (though perhaps an imper-
fect one) for owning, market forces
drive the prices of equivalent rented
and owned units together. As a result,
ending the tax deduction for mortgage
interest would change the price of all
housing units, affecting everyone.

Conclusion

Needless to say, predicting the out-
come of such large tax changes on
interest rates and home values is diffi-
cult. To model such changes, it is nec-
essary to capture the effects throughout
the economy, which requires an elabo-
rate framework. It is evident, how-
ever, that the effects will not be borne
equally across households at different
income and wealth levels.

Because higher-income families now
enjoy most of the benefits of the mort-
gage interest deduction, they would
be expected to suffer most from its
elimination. However, it is exactly
the higher income groups who would
benefit from other aspects of the pro-
posed flat tax systems. As we can
infer from tables 1 and 2, those most
affected by removal of the mortgage
interest deduction are those who also
have invested much less of their over-
all wealth in their homes. If the tax
change leads to increased economic
growth, then their income from other
sources will rise. The value of other
assets will also increase as the distort-
ing effects of the preference for owner-
occupied housing are taken away.

Although there may be deleterious
effects on housing prices, the wel-
fare of individuals need not dimin-
ish because of such changes in the tax
code as adopting a flat tax and elimi-
nating the mortgage interest deduction.

This Economic Commentary has
focused exclusively on mortgage
interest rates and housing prices, but
a similar calculus is also relevant to
other policies that may affect taxes
or benefits. Well-intentioned propos-
als directed toward specific areas may
have unanticipated, yet far-reaching,
effects. As relative prices change (for
example, as a result of making college
tuition deductible, removing farm price
supports, decreasing tariffs, or allow-

TABLE 1 HOME OWNERSHIP AND WEALTH

<table>
<thead>
<tr>
<th>Annual family income</th>
<th>Percent owning family residence</th>
<th>Percent of wealth attributable to housing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $10,000</td>
<td>38.8</td>
<td>90.3</td>
</tr>
<tr>
<td>$10,000 to $24,999</td>
<td>54.2</td>
<td>68.5</td>
</tr>
<tr>
<td>$25,000 to $49,999</td>
<td>68.8</td>
<td>52.0</td>
</tr>
<tr>
<td>$50,000 to $99,999</td>
<td>84.2</td>
<td>40.5</td>
</tr>
<tr>
<td>$100,000 and over</td>
<td>87.6</td>
<td>17.0</td>
</tr>
</tbody>
</table>


TABLE 2 BENEFITS OF THE MORTGAGE INTEREST DEDUCTION

<table>
<thead>
<tr>
<th>Annual family income</th>
<th>Tax returns</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Percent itemized</td>
</tr>
<tr>
<td>Less than $10,000</td>
<td>0.7</td>
</tr>
<tr>
<td>$10,000 to $19,999</td>
<td>3.5</td>
</tr>
<tr>
<td>$20,000 to $29,999</td>
<td>9.9</td>
</tr>
<tr>
<td>$30,000 to $39,999</td>
<td>21.0</td>
</tr>
<tr>
<td>$40,000 to $49,999</td>
<td>34.2</td>
</tr>
<tr>
<td>$50,000 to $74,999</td>
<td>55.7</td>
</tr>
<tr>
<td>$75,000 to $99,999</td>
<td>79.0</td>
</tr>
<tr>
<td>$100,000 to $199,999</td>
<td>89.7</td>
</tr>
<tr>
<td>$200,000 and over</td>
<td>93.7</td>
</tr>
</tbody>
</table>

ing a tax credit for children), there will be changes in other markets as consumers substitute away from costlier products to cheaper ones. To determine the final outcome of such policies, it is important to examine their possible effects throughout the economy as it settles into a new equilibrium.

**Footnotes**

1. In the current tax system, the deductibility of home-mortgage interest follows logically from the fact that interest income is taxable, while corporate tax payments are not.

2. They might also consider the prospect for capital appreciation. During some periods, the belief in ever-increasing housing prices seems to have led some people to purchase more costly homes than they otherwise would have.


5. One would expect that eliminating the tax preference for housing would shift capital toward the corporate sector. As Martin Feldstein has shown, there is a distinct possibility this would raise the equilibrium interest rate. See “The Effect of a Consumption Tax on the Rate of Interest,” NBER Working Paper No. 5397, December 1995.

6. With an income tax you are taxed twice: Because most savings are after tax, you pay on income before you save and again on any income that those savings generate.


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The views expressed here are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or the Board of Governors of the Federal Reserve System or its staff.

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