

BUILDING A NATION OF HOMEOWNERS

Making the dream of homeownership accessible to all Americans

Owning a home is an integral part of the American Dream. More than three in four American families say that home ownership is a priority for them.¹ This should come as no surprise, since home ownership brings such varied and far-reaching benefits. Escaping the cycle of paying rent without building equity helps families accumulate wealth and achieve economic security.

- Homes comprise two-thirds of the wealth of low-income and minority families.²
- On average, low-income homeowners have 12 times the wealth of low-income renters.³

Less obvious, but no less important, are the indirect benefits of home ownership:

- Homeowners enjoy higher life-satisfaction and more consistent employment.⁴
- Children of homeowners perform better in school and earn, on average, \$150,000 more over their lifetimes than their peers who grew up in rental housing.⁵
- High homeownership rates also help build strong communities, producing safer streets, greater civic engagement, and improved property upkeep.⁶ Increased home ownership in parts of New York City, for instance, has significantly raised property values in the surrounding neighborhoods.⁷

In short, buying a home is the main ticket to the middle class for millions of families.

Between 1979 and 1995, the rate of homeownership in the US reached a plateau of around 63% of households. Since the mid-1990s, rising incomes and historically low interest rates have helped push the home ownership rate to an all-time high of 68%, a rate that is among the very highest in the world.⁸ And booming home construction—more than 1.25 million new homes in 2001 alone⁹—has created thousands of jobs and helped to keep the weak economy afloat. Without question, the housing sector is a bright spot for America. But while more families than ever before live in their own homes, millions more have been left behind.

- Home prices in most metropolitan areas have increased much faster than incomes over the last two decades, putting even modest homes beyond the reach of many working and middle-class families.¹⁰
- Almost 40% of renters say that owning a home is a top priority, but are unable to find one that they can afford.¹¹

- Minority families face a particularly uphill battle, with homeownership rates still more than twenty percentage points below those of white families.

Persistent constraints on both the supply and demand for single-family homes are largely to blame for these ongoing challenges. New and innovative policy proposals are needed to overcome these challenges and create equality of opportunity for homeownership among all Americans.

Making homes more affordable: downpayment assistance for first-time buyers

Some renters who would prefer to own don't earn enough to make a monthly mortgage payment on a moderately priced home. Weak credit locks some of these families out of home loans completely. Others could get approval, but only at high interest rates that would drive monthly payments beyond affordability. To put more of these credit-constrained families into new homes, the most important thing Washington can do is maintain sensible fiscal and monetary policies that keep interest rates low once the economy gets moving again.¹²

But for fully one-third of renters, a good economy is not enough. The problem instead lies in gathering the resources to meet the upfront costs of buying a home. These families have the income to make a moderate monthly mortgage payment, but lack the wealth to make the necessary down payment.¹³ They need just a small boost to get over this hump and into a home of their own. The federal government can provide that boost in the form of \$5000 grants or tax credits to be used against down payment and closing costs. Such grants would be available to any current renter meeting certain income criteria. In combination with a program to stimulate home construction, these grants could help put five million more households in their own homes in the next five years. This proposal is designed to help more families get into their first homes, using fewer tax dollars to do it than any other approach.

Making homes more plentiful: a tax credit to spur affordable home construction

Most communities simply do not build enough moderately priced homes. Developers face significant barriers in the form of NIMBYism from established residents and exclusionary zoning processes. Financially strapped local governments are more likely to approve commercial or high-income housing developments, since both produce more tax revenue than moderately priced homes. Even when permits are available, economic conditions often do not support new housing. In many regions, the cost of building or renovating exceeds the value of the completed home.

Since zoning and other regulatory decisions are made at the local level, the federal government has limited power to cut the red tape. However, the federal tax code can provide the most effective tool to boost home construction in the form of tax credits to

developers of affordable single-family homes. Today, many plans to build or renovate moderately priced single-family homes never get off the drawing board because excessive regulation or weak markets would make them unprofitable. But a tax credit that reduces the effective construction cost would make many of these projects economically viable, spurring the construction of hundreds of thousands of new homes.

This approach has a long and successful track record in creating more rental housing. Since 1987, developers have bid for tax write-offs for the development of multifamily rental units, contributing to the construction of more than a million new units.¹⁴ By spending just over half as much as is spent today on tax credits for rental housing developers, we could spur the development of 1 million new homes over the next five years. That's enough new homes to satisfy the additional demand created by the down payment assistance initiative, so enough affordable homes are available for sale.

High aspirations in an era of budget shortfalls

Today, too many families compete for too few homes. This has deprived millions of families of the chance to own a home, while burdening millions more with unsustainably high monthly mortgage payments.¹⁵

The good news is that, in partnership with private and non-profit housing providers, government can help to make homes both more plentiful and more affordable for all Americans. These initiatives are not free. But we can defray much of the cost by selectively reallocating some of our current spending on pro-homeownership initiatives. For example, the mortgage interest tax deduction is an important benefit to owning a home for many Americans, but it is a benefit that costs the government billions of dollars each year without doing much to increase homeownership because it applies equally to high-end homes and second/vacation homes as well as to moderately priced first homes. By refining and refocusing the mortgage interest tax deduction, we could reduce the net cost of these new initiatives to just \$2.5 billion. That's less than ten percent of the annual HUD budget and less than three percent of the annual tax expenditure on housing tax deductions¹⁶ – a small price to pay for equality of opportunity for homeownership among all Americans.

Policy implementation and details

For more than half a century, the federal government has recognized the importance of homeownership and affordable housing. Direct spending and tax expenditures for home ownership now total over \$120 billion annually.¹⁷ These programs are widely popular and can point to important successes, but most of the benefits have gone to either (1) renters, or (2) relatively high-income owners buying high-priced homes. Low and moderate-income homebuyers have received little help. These

proposals attempt to address this policy gap in a high-impact, cost-effective, and largely revenue-neutral fashion.

Down payment assistance for first-time buyers – the “Five 5’s Approach”

Rationale and program administration

A down payment subsidy is the most effective means of helping people afford to buy a home. Eighty-eight percent of renters cannot afford a house selling for just half the regional average.¹⁸ Almost everyone in this group is held back partly by savings that are inadequate to meet the upfront costs of buying a home—so programs that only reduce a homebuyer’s monthly payment are not enough to help him or her afford to buy. For instance, reducing the effective interest rate by a full 3 percentage points increases the numbers of renters able to afford to buy a modestly priced home by less than one percentage point.¹⁹

By contrast, upfront costs (down payment and closing costs) block fully 35% of renters from buying a home.²⁰ In other words, over one third of those who might want to buy their own home can afford the mortgage payments, if only they could find the financial resources to manage the down payment and closing costs. Lenders have responded by offering low down-payment programs to help would-be homebuyers who lack the savings to meet the upfront costs—but at the cost of high interest rates and monthly payments. That’s why down payment assistance makes good sense.

In general terms, here’s how the program would work. Renters would apply for the grant through a state housing agency, which would determine eligibility based on the availability of funds and the number of households applying. The state housing agency would have discretion to identify eligible recipients and distribute the funds to first-time homebuyers in the most effective way.

Impact

No other way of increasing homeownership achieves as much per dollar spent. This approach, referred to as the “Five 5’s,” would fund the \$5000 grant initiative at \$5 billion per year for 5 years, helping to put 5 million more families into their own homes and raising the homeownership rate by 5%.

A subsidy of \$5000 is the smallest grant amount that will make a substantial difference in the number of families able to purchase their first homes.²¹ Smaller subsidies are insufficient for most families; larger subsidies are unnecessary for many families. The chart below indicates the percent of renters who can afford a moderately priced home at various levels of down payment subsidy:²²

Table 1: Share of Renters Who Could Afford a Home with a Down Payment Subsidy

With no subsidy	10.2%
With \$1000 subsidy	11%
With \$2500 Subsidy	12.6%
With \$5000 subsidy	21.2%
With \$7500 subsidy	27.7%
With \$10,000 subsidy	31.9%

A \$5000 subsidy would allow 21.2% of the nation's 35 million renting households, or 7 million households, to afford to purchase a home. An estimated 75% of these households would take advantage of the subsidy to purchase a home, since three in four Americans who currently rent report that they want to own. Thus, with the assistance of this grant, approximately 5 million households could be expected to purchase a home as a result of this program in the 5 years after the program is launched.

Tax credits for developing affordable single-family homes

Rationale and program administration

In many housing markets across the country, housing shortages and swiftly rising home prices are overwhelming the resources of low- and moderate-income families. Often, these communities need better incentives to build or renovate affordable homes for single families.

Numerous and widespread regulatory obstacles create delay and higher costs for developers. Many communities shun affordable housing, fearing a diminution in property values. In addition, short-term local financing incentives discourage zoning for affordable housing: retail development brings in sales taxes and expensive homes bring in substantially higher property taxes, while residents of affordable homes often consume more in local services than they return in property taxes.²³ Finally, weak demand in many central cities and rural areas often means that the cost of construction or rehabilitation is greater than the selling price that the market will deliver.

How can we reduce the construction and renovation cost of homes to encourage developers to build and rehabilitate more units? One option, proven successful by history, is to provide tax credits to developers. For more than fifteen years, developers have bid on tax credits for the development of multifamily rental housing, contributing to the construction of more than a million new units. The federal government hands out over \$4 billion annually in rental housing development credits through this program, called the Low-Income Housing Tax Credit (LIHTC).²⁴

The affordable home development tax credit would be administered much like the LIHTC.²⁵ State housing agencies would identify qualifying proposals and auction off the tax credits to the highest bidder. To ensure that the credit would be used to build affordable homes, eligibility would be limited to development on low-income census tracts and developers would be required to sell to buyers earning less than 80% of the region's median income. The credit could be used to offset the costs of building or refurbishing moderately priced homes in areas where those costs would be higher than the value of the home, perhaps up to 50% of the total cost of the project.

Impact

The Department of Housing and Urban Development estimates that \$500 million in tax credits will build 40,000 additional homes per year.²⁶ Last year there were 6.2 million homes sales, and 1.27 million new home starts.²⁷ If five million families used downpayment assistance to purchase their first home in the next five years, the number of home sales would increase by approximately 1 million each year. This would entail a proportional scaling up of new home starts to just under 1.5 million per year, an increase of about 200,000 per year. We therefore propose to provide \$2.5 billion in tax credits annually, with the goal of encouraging homebuilders to develop an additional one million homes over the next five years.

Adjusting the mortgage interest tax deduction

The Five 5's Approach and the Affordable Home Development Tax Credit is a sensible investment that could appropriately be funded out of savings elsewhere in the federal budget. However, the program can also be implemented without major additional costs to federal government if we reallocate a small fraction of the housing dollars we already spend, with an eye toward refocusing subsidies towards those who need them most. The mortgage interest tax deduction, which makes sense as a way to help low- and moderate-income families afford to buy a home, is a good place to start.

Limiting mortgage interest deductibility to mortgage principals below \$300,000

Those Americans already able to afford "high-end" homes do not really need the boost provided by mortgage interest deduction that is so critical for working and middle class Americans. By limiting the maximum amount of mortgage principal on which interest payments could be deducted to \$300,000, we could reallocate the savings to the Five 5's Approach and the Affordable Home Development Tax Credit.

Although eliminating the tax deductibility of interest on mortgage principals between \$300,000 and \$1 million may seem drastic at first, that the reality is that only 7% of homes sell for more than \$300,000, affecting just over one million homebuyers.²⁸ And most of these buyers would retain the lion's share of the mortgage tax deduction, since

the deduction would be eliminated only for the amount of the principal above \$300,000. Additionally, as a matter of implementation, the policy could “grandfather” existing mortgages so as not to disrupt these households' current finances. This would slow the reallocation of resources from existing high-end mortgages to the policies describes herein, but would also reduce opposition from families that had made financial plans based upon the deductibility of their interest payments on high-end homes.

Eliminating the deductibility of interest on second/vacation home mortgages

Additional savings can be reallocated to the Five 5’s Approach and the Affordable Home Development Tax Credit if the mortgage interest tax deduction is revised to apply only to the purchase of a primary residence. Extending mortgage interest tax deductibility to second/vacation homes does nothing towards achieving the goal of equality of opportunity for homeownership among all Americans. Federal “spending” on mortgage interest tax deductions for second/vacation homes is better allocated to these new home ownership initiatives.

By limiting the mortgage interest deductibility and eliminating interest deductions for second/vacation homes, the government could reallocate approximately \$25 billion over 5 years —enough money to pay for the down payment assistance—without pricing anyone out of a home of their own.

Financial costs

The total net cost of these initiatives is estimated at \$2.5 billion annually. The following summarizes the cost of the down payment and tax credit initiatives proposed above, along with the savings achieved by adjusting the mortgage interest tax deduction.

Table 2: Net Fiscal Cost of Home Ownership Proposals

Policy measure	Annual cost (savings)	Source of figure or calculation
Down payment assistance	\$5 billion	\$5000 grants for each of 5 million families over 5 years
Tax credit for single-family home construction	\$2.5 billion	Estimate of expenditure needed to build 1 million new homes (based on HUD figures)
Reduction of maximum mortgage principal on which interest can be deducted to \$300,000	(\$4.3 billion)	Congressional Budget Office (would be smaller at first if provisions were grandfathered)
Elimination of mortgage interest tax deduction for second homes	(\$0.7 billion)	

Political issues

Policies similar to these proposals, but much more modest, have been promulgated by the Bush Administration.

The Administration has declared that increasing homeownership, especially among minorities, is the centerpiece of its housing agenda. To its credit, it has introduced both demand and supply-side initiatives along the lines of those proposals here. The American Dream Downpayment Fund provides down payment assistance to families buying their first homes, while an expansion of the Low-Income Housing Tax Credit makes available incentives to developers of affordable single-family homes.

The major shortcoming of these initiatives is that they bark much louder than they bite: they provide only 40,000 families with down payment grants each year, and authorize only enough tax credits to build 40,000 additional new homes.²⁹ Even if these aspirations are fully met, they will barely budge the national homeownership rate. By rationalizing the way we spend our housing dollars, the approach outlined here will help 25 times more families afford a new home and facilitate the construction of 5 times more homes—with a net cost of just \$2.5 billion. These proposals promise, credibly, to deliver much more than current Administration initiatives do.

Because these proposals use market-friendly approaches to achieve progressive goals, they contain the ingredients to generate broad support

This approach should have widespread appeal. Child advocates, service sector labor unions, and other progressive groups should support a program that provides high-impact, targeted assistance to low- and moderate-income families. Family-focused and religious organizations will appreciate the value of stabilizing the home environment for millions of families and children. Business groups in general and the home building industry in particular will strongly support both down payment assistance and tax incentives to build more affordable housing.³⁰ This stimulus and market opportunity is likely to offset the industry's opposition to any limitation to the mortgage interest tax deduction. And many Americans have experienced the across-the-board run-up in home prices in recent years, creating an opportunity to persuasively argue that something must be done to make homes more plentiful and affordable.

On the other hand, the benefits of this set of policies do not come without some political risk. Many buyers of homes above \$300,000, especially in high-cost markets, will not view themselves as affluent buyers, and could be mobilized to attack the program as “anti-middle-class.” Even if they maintain most of their tax deductions, and also obtain some grandfathering protection, their homes might appreciate in value more slowly if potential future buyers know that they cannot deduct the full interest payments. To defuse this challenge, those championing these policies will need to get out in front early

– reaching out to the affected interest groups, demonstrating that the vast majority of home buyers would maintain the bulk of their benefits, and rallying support among the potential beneficiaries of such a shift.

Rebuttals to arguments against

“We can’t afford new programs that would create billions in subsidies for homebuyers and home builders.”

Response: The net cost of these policies to the federal government would be less than \$2.5 billion per year. This is just over one tenth of one percent of the government’s annual total spending. Moreover, we already spend tens of billions annually on home ownership programs and tax incentives whose impact is often murky. In contrast, these new proposals achieve maximum bang for the buck.

“Reducing the ceiling on mortgage interest tax deductions would impose big new costs on homeowners, making it harder to purchase a home and reducing home building and homeownership rates.”

Response: The effect of mortgage interest tax deductions on home ownership rates is actually very small. Because this policy would merely reduce the ceiling on interest that can be deducted as opposed to eliminating the deduction altogether, it would have a still smaller effect.

- A study³¹ by the University of California Center for Real Estate and Urban Economics concluded that the mortgage interest tax deduction only boosts home ownership rates by 1.7%, in part because one major effect of the deduction is to allow people who would buy homes anyway to buy more expensive homes. If the tax deduction were limited to the first \$300,000 of mortgage principal, only a tiny fraction of that 1.7%, mainly in a few major metropolitan areas with unusually high housing costs, would no longer be able to afford a home of their own.
- The impact on homeownership rates from reducing the mortgage interest tax deduction ceiling is likely to be more than offset by the boost to demand created by the down payment subsidies.
- The mortgage interest tax deduction is basically a program for the middle-class and wealthy, with more than 90% of the benefits accruing to people with incomes over \$50,000. By making the tax code more regressive, it reduces the share of income held by those who are struggling to accumulate the resources to buy their own homes. Capping the deduction at \$300,000 would affect only the most affluent in all but the several most expensive regions in the country—and the affluent will always be able to buy their own homes.

Moreover, the introduction of much more generous tax credits to spur affordable home building would both reduce the price of homes and give the home building industry a shot in the arm. The overall effects on homeownership would be strongly positive.

“Simply giving every would-be homeowner \$5000 for a down payment is wasteful and ineffective government spending.”

Response: The federal government devotes more than \$100 billion each year to programs that promote home ownership, a commitment that goes back almost a century. But most of spending is poorly targeted to boost the home ownership rate. This proposal includes very little new spending. Instead it relies on a fairer, more cost-effective allocation of a portion of existing spending.

Moreover, the subsidy is crafted to maximize impact. Helping families with the upfront costs of purchasing a home is the most cost-effective way to help people afford their own homes, and pegging the amount of the fund at \$5000 per household provides enough help to put 5 million more households in their own homes without giving more than necessary.

“This proposal does not address local regulatory barriers or homeowner education programs, both of which make a crucial difference in promoting or hindering homeownership.”

Response: There is no question that local regulatory barriers are a major obstacle to home building and therefore to home ownership. The local control that creates these barriers must be preserved. But the local challenges facing developers make federal intervention all the more important. Because the market incentives to build affordable homes are blunted, federal incentives are crucial. Tax breaks to developers of the sort proposed here are designed to let builders get back to building.

And homeowner education programs are indeed important. Research shows that homebuyers who receive classroom instruction are 23% less likely to be delinquent with their mortgage payments after 50 days; those who get one-on-one counseling are 41% less likely. The Bush Administration proposes to increase funding for non-profit housing organizations by 200% and for homeowner education by 75% to \$35 million. These initiatives make sense, and if effective, should be expanded further. Such policies would also make it easier for national leaders to use their bully pulpit to encourage states and localities to change these regulations. Additionally, during implementation, these programs could be disproportionately geared (particularly in the early years) towards those localities with the most rational local land use policies, as a way of encouraging more sensible approaches on a state and local level.

¹ Eric Stein and Martin Eakes, “Achieving the American Dream,” Progressive Policy Institute online article. Available at http://www.ppionline.org/ppi_ci.cfm?contentid=1346&knlgAreaID=114&subsecid=236.

² Ibid.

³ Ibid.

⁴ Michael H. Schill and Susan Wachter, “Principles to Guide Housing Policy at the Beginning of the Millenium.” Available at <http://www.huduser.org/publications/pdf/brd/01Schill.pdf>.

⁵ “Achieving the American Dream.”

⁶ See, for example, William M. Rohe, Shannon van Zandt, and George McCarthy, “Social Benefits and Costs of Homeownership,” in *Low Income Homeownership*, Nicholas P. Retsinas and Eric S. Belsky, Editors (Washington, D.C.: Brooking Institution Press, 2002).

⁷ Ingrid Gould Ellen, Michael H. Schill, Scott Susin, and Ellen Schwartz, “Building Homes, Reviving Neighborhoods,” in *Low Income Homeownership*.

⁸ According to U.S. Census figures.

⁹ “The State of the Nation’s Housing 2002,” Joint Center for Housing Studies of Harvard University. Available at <http://www.jchs.harvard.edu/publications/markets/Son2002.pdf>.

¹⁰ See, for example, David Leonhardt, “Earning More, But Struggling to Own a Home,” *The New York Times*, November 4, 2002.

¹¹ “Achieving the American Dream.”

¹² Low-income families’ chances to gain approval for home loans are also hampered by discriminatory credit assessment practices—practices that the government can help to end. See, for example, Anne Kim, “Giving Credit Where It’s Due,” Progressive Policy Institute online article. Available at http://www.ppionline.org/ppi_ci.cfm?contentid=250212&knlgAreaID=114&subsecid=236.

¹³ “Achieving the American Dream.”

¹⁴ <http://www.brookings.org/dybdocroot/ES/urban/publications/retsinas.pdf>

¹⁵ Over a third of low-income homeowners are moderately or severely burdened by housing costs. Many have not been able to keep up with monthly payments, producing the highest foreclosure rates in 30 years.

¹⁶ Millennial Housing Commission report appendix. Available at www.mhc.gov.

¹⁷ National Low Income Housing Coalition, *Changing Priorities: The Federal Budget and Housing Assistance, 1996-2002* (Washington, D.C.: NLIHC, 2002).

¹⁸ “Achieving the American Dream”

¹⁹ Howard Savage, “Who Could Afford to Buy a House in 1995?”, US Census publication available at <http://www.census.gov/prod/99pubs/h121-991.pdf>

²⁰ “Achieving the American Dream”

²¹ This amount could be adjusted to reflect local market conditions, but the ease of marketing and administering a flat subsidy is likely to trump this concern.

²² “Who Could Afford to Buy a House in 1995?”

²³ Note, however, that this short-sighted calculus ignores the environmental and transportation costs of compelling police, firemen, and teachers to commute long distances to work in wealthier communities.

²⁴ Millennial Housing Commission appendix, available at www.mhc.gov.

²⁵ For more detail, see a policy option paper presented to the Millennial Housing Commission, “Recommendation #1: Enact A Homeownership Tax Credit Similar To The LIHTC That Will Stimulate Production Of Units For Homeownership.” Available at <http://www.mhc.gov/papers/hotc.doc>.

²⁶ Cited in the President’s report on increasing homeownership, available at <http://www.whitehouse.gov/infocus/homeownership/homeownership-policy-book-ch1.html#taxcredit>

²⁷ “The State of the Nation’s Housing 2002.”

²⁸ Congressional Budget Office. Available at http://www.cbo.gov/bo2001/bo2001_showhit1.cfm?index=REV-01

²⁹ <http://www.whitehouse.gov/infocus/homeownership>

³⁰ See <http://www.nahb.org/generic.aspx?sectionID=200&genericContentID=3525>

³¹ Kenneth Rosen, “The Mortgage Interest Tax Deduction and Home Ownership.” Working Paper 89-159 (1989).