



Abt Associates Inc.

Cambridge, MA
Lexington, MA
Hadley, MA
Bethesda, MD
Washington, DC
Chicago, IL
Cairo, Egypt
Johannesburg, South Africa

Abt Associates Inc.
55 Wheeler Street
Cambridge, MA 02138

Low Income Homeownership through Tax Credits:

A Review of Design Choices

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108 North Cayuga Street, 2nd Floor
Ithaca, NY 14850

Prepared by
Jill Khadduri
Austin Kelly
Laura Talle

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Introduction

The national policy agenda includes active discussion of expanding homeownership subsidies for low-income households. There were two Bush Administration proposals in 2001: a single family homeownership tax credit modeled on the rental Low Income Housing Tax Credit (LIHTC) and a \$200 million set-aside of HOME program funds for downpayment assistance. Congress enacted the HOME downpayment assistance program in the fiscal year 2002 Appropriations Act, but reduced the amount to \$50 million and made the use of funds subject to the (unlikely) enactment of authorizing legislation by June 2002.

The Millennial Housing Commission, which plans to report to Congress in May 2002, has been considering options, including tax credits, for removing barriers to homeownership for low-income households. The Bush tax credit was not elaborated during 2001 as a detailed legislative proposal, but could be placed before Congress during 2002. Congress no doubt also will be asked again to consider a set-aside of HOME funds.

One reason that tax credits for low-income homeowners are under consideration is the belief that the current tax code is inequitable in that the largest single housing subsidy, the mortgage interest deduction, provides little benefit to low-income households. Another reason is that tax credits are perceived to be a more viable approach politically for expanding the total resources devoted to housing subsidies than are appropriations for direct governmental expenditures.

In order to inform the current policy debate, the Neighborhood Reinvestment Corporation asked Abt Associates to review the advantages and disadvantages of different approaches for supporting homeownership through tax credits. This paper responds to that request. In Section I we present four approaches for designing a tax credit subsidy for low-income homebuyers and set forth the criteria we believe that policy-makers should use in evaluating those approaches. This section also provides a summary of the study's findings regarding the strengths and weaknesses of the four program models evaluated against those criteria.

Section II provides a detailed assessment of each of the program models, including its strengths and weaknesses and specific program features that might mitigate the weaknesses of the approach and enhance its strengths.

I. Summary Assessment of Four Program Models

This section sets out four approaches to designing a tax credit for low-income homebuyers, discusses the criteria that should be used in assessing the merits of alternative approaches, and provides a brief assessment of the four models.

There are many design choices for a homeownership tax credit.

- Is the subsidy delivered through a housing developer, a mortgage lending institution, or directly to the homebuyer;
- Is the subsidy attached to a homebuyer or to a specific housing unit;
- Does the subsidy write down the cost of the housing unit or the cost of borrowing;¹
- Is the program targeted to specific households and, if so, which group;
- Is the program targeted to specific geographic areas and, if so, to which areas; and
- Does the subsidy belong to the household permanently or is it recaptured?

Another key feature is the level of government that allocates the subsidy. We will simplify the discussion by assuming, as most current proposals for tax credits do, that state governments would receive a capped amount of tax credit authority and would then allocate the credits to delivery agents or users.²

The four approaches examined are:

1. A subsidy for the development cost of new or substantially rehabilitated housing sold at a market price that is affordable for households with income below 80 percent of area median income. This is the Bush Administration proposal, which we will call the **Single Family Homeownership Tax Credit**.³ We have based our analysis in part on a draft legislative proposal circulated by group of housing industry participants, which may not be consistent with the Administration's intentions.
2. A lender-based mortgage subsidy for housing selected by the homebuyer, financed through a tax credit allocated to the states. We call this approach a **Mortgage Subsidy Tax Credit**. It differs

¹ A subsidy for the cost of the housing unit could be a write-down of the sales price or a subsidy for development costs. A subsidy for the cost of borrowing could lower the monthly costs of homeownership by lowering the mortgage interest; it could subsidize the up-front costs of homeownership through downpayment or closing cost assistance, or it could subsidize the removal of credit barriers through low cost mortgage insurance. Depending on how it is structured, downpayment assistance may in effect be a write-down of the sales price.

² State governments also would allocate the HOME set-aside of downpayment assistance as it was proposed by the Bush Administration for the FY 2002 budget.

³ The Administration's FY 2002 budget materials called it the Renewing the Dream Tax Credit.

from current proposals for a lender-based tax credit (for example, the Roybal-Allard bill and a proposal circulated by the Mortgage Guaranty Insurance Corporation) in that the subsidy could be delivered through a first mortgage, a second mortgage, or mortgage insurance, at the discretion of the allocating agency.

3. A **First-Time Buyer Tax Credit** taken directly by eligible homebuyers. Legislation proposed by Congressman English would enact such a credit. A similar credit exists now for homebuyers in the District of Columbia.
4. A **Flexible Tax Credit** allocated to the states, with the states choosing whether to use the Single Family Homeownership Tax Credit, the Mortgage Subsidy Tax Credit, or both. The Millennial Housing Commission may recommend this program design.

Table 1 compares the basic design choices for each of these four approaches.

Table 1: Four Program Models

	Delivery system	Eligible housing	Form of subsidy
Single family homeownership tax credit	Developer uses tax credit or sells to investor; sells units to homeowners	Specific new and substantially rehabilitated units	Write down of construction costs to appraised value of house
Mortgage subsidy tax credit	Lender or mortgage insurer uses tax credit or sells to investors along with below-market financial instruments, lends mortgage funds to homebuyers or insures mortgages	Chosen by homebuyer	Below market first mortgage, second mortgage subsidizing downpayment and closing costs, and/or subsidized deep mortgage insurance
First time buyer tax credit	Individual homebuyer takes tax credit equal to a fraction of sales price	Chosen by homebuyer	Downpayment assistance: indirect sales price write down
Flexible tax credit	Allocating agency determines if tax credit is used by developers, lenders, or both	Specific units or chosen by homebuyer	Sales price write down, write down of construction costs, below market first mortgage, second mortgage for downpayment and closing costs, and/or subsidized mortgage insurance
	Household targeting	Geographic targeting	Recapture of subsidy from homebuyer
Single family homeownership tax credit	Households with income below 80 percent of area median income (70 percent for one or two-person households)	Census tracts with average income below 80 percent of area median income	The lesser of 80 percent of gain or a declining percentage of the value of the tax credit (phasing out after 3 years) would be recaptured upon resale from a household no longer below the income limit
Mortgage subsidy tax credit	First-time buyers with income below 80 percent of area median, fully adjusted for household size	None*	None**
First time buyer tax credit	First-time buyers. Income limits are not specified in current proposals	None	None
Flexible tax credit	Households with income below 80 percent of area median, fully adjusted for household size	At discretion of allocating agency, depending on program chosen	At discretion of allocating agency, depending on program chosen
*The MGIC proposal makes first-time buyers eligible with no income limit in "HUD-targeted zones."			
**The Roybal-Allard bill has a "light" recapture provision explained in footnote 39, p. 23, below.			

1.1 Criteria for Choosing Among Models

Several criteria should be considered in assessing the design of any homeownership subsidy program:

- the extent to which the program can address all of the major barriers to homeownership: income, wealth and credit constraints;
- the risk that the subsidy will go mainly to households who would have become homeowners anyway;
- the risk that a program with place-based objectives will not reach the intended neighborhoods or will have a negative effect on neighborhoods; and
- the size of program inefficiencies, including investor returns, transaction costs, and monitoring costs.

There may be trade-offs among these criteria, and their importance may vary depending on the basic purpose of the program: for example, whether it is intended to expand homeownership among low-income households, to expand the range of housing choices available to those households, or to improve the neighborhoods in which the program is used.

1. The extent to which the program can address the major constraints faced by low-income homebuyers.

Low-income households face three types of barriers to becoming homeowners: wealth, income, and credit. Wealth constraints limit a household's ability to pay for downpayment and closing costs. Income constraints limit the household's ability to meet the monthly costs of homeownership, including mortgage payments. Impaired credit and excessive non-housing debt are frequent barriers to homebuying for households who otherwise can find a house to buy for which they would not face income or wealth constraints. Current research suggests that wealth and credit constraints are more important than income constraints for a large fraction of those low-income households that would want to become homeowners.⁴ Both wealth and credit constraints are particularly great for minorities.⁵ For example, based on Home Mortgage Disclosure Act (HMDA) data, it has been estimated that 46 percent of African Americans whose applications for mortgage loans were denied were rejected because of high debt-to-income burdens and blemished credit histories.⁶

⁴ The literature on wealth versus income constraints is summarized in Mark Duda and Eric S. Belsky, "The Anatomy of the Low-Income Homeownership Boom in the 1990s," Joint Center for Housing Studies of Harvard University, Low Income Homeownership Working Paper Series, July 2001, pp.4-6.

⁵ David Listokin, Elvin K. Wyly, Brian Schmitt, and Ian Voicu, "The Potential and Limitations of Mortgage Innovation in Fostering Homeownership in the United States," *Housing Policy Debate*, 12:3, pp.465-513. Donald R. Haurin, Patrick H. Hendershott, and Susan M. Wachter, "Borrowing Constraints and Tenure Choice of Young Households," *Journal of Housing Research*, 8:2 (1997), pp. 137-154.

⁶ Roberto G. Quercia, Michael A. Stegman, Walter R. Davis, and Eric Stein, "Community Reinvestment Lending: A Description and Contrast of Loan Products and Their Performance," Joint Center for Housing Studies of Harvard University, Low Income Homeownership Working Paper Series, September 2001, p.3.

2. The risk of providing subsidy mainly for households who would have become homeowners anyway.

At any income level, there are households that would become homeowners in the absence of a subsidy. Even for households with incomes below 80 percent of area median income the homeownership rate is greater than 50 percent, and it is close to 60 percent for those with incomes between 51 and 80 percent of median.⁷

Furthermore, many households with modest incomes are in the earliest stages of their careers and will have substantial income increases within a relatively brief number of years. Therefore, programs that subsidize homeownership may simply advance homeownership by a few years for many households or may permit households who would have bought in any case to buy larger or better-located homes than they otherwise could afford.⁸

The mortgage innovations of both the primary and secondary markets during the 1990s further increased the number of low-income households able to become homebuyers.⁹ For a variety of reasons, rates of home buying by low-income and minority households increased during that period.¹⁰

3. The risk that a program with place-based objectives will not achieve its goals or may not reach the right neighborhoods

Homeownership programs can pursue goals other than moving households from renter to homeowner status. If a rehabilitation component is included or if the program produces infill units in older neighborhoods, the program can improve the condition of existing homes in deteriorating neighborhoods. Even without rehabilitation, the program may increase the homeownership rate in particular neighborhoods, supporting overall neighborhood stabilization or revitalization.

⁷ Within metro areas, the homeownership rate for households with incomes between 51 and 80 percent of median is 56.9 percent. For metro and non-metro areas combined, it is 59.5 percent. Even if the elderly, whose incomes may well have declined since they became homeowners, are excluded, the homeownership rate for households with incomes between 51 and 80 percent of median is just over 50 percent. Figures based on 1999 American Housing Survey.

⁸ Stuart S. Rosenthal, *Eliminating Credit Barriers to Increase Homeownership: How Far Can We Go?* Research Institute for Housing America, March 2001, finds that “borrowing constraints depress owner-occupancy rates in part by delaying homeownership rather than by permanently excluding families from owner-occupied housing,” p.19. Goodman and Nichols came to the same conclusion about FHA mortgage insurance. John L. Goodman, Jr., and Joseph Nichols, “Does FHA Increase Home Ownership or Just Accelerate It?” *Journal of Housing Economics* 6:2, 1997, pp.184-202.

⁹ Quercia, and others, pp. 7-9. Listokin, Wyly, Schmitt, and Voicu use SIPP (Survey of Income and Program Participation) data to estimate the potential extent of this increase for various new mortgage products and population subgroups and conclude that it is modest. They point out that actual homebuying by renters in the SIPP survey exceeds their estimates, perhaps because renters who have decided to become homeowners take steps to increase both their income and their savings. *Op.Cit.*

¹⁰ Duda and Belsky, pp.1-2. Raphael W. Bostic and Brian J. Surette found that homeownership rates for low-income and minority families increased more sharply than for other families from 1989 through 1998 and that changes in family-related characteristics were largely *not* responsible for those increases. “Have the Doors Opened Wider? Trends in Homeownership Rates by Race and Income,” Board of Governors of the Federal Reserve system, September 2000.

Whether there will be any neighborhood effect at all depends on the scale of the program in a particular neighborhood. In addition, whether neighborhood effects will be positive or negative is ambiguous. On the one hand, a program that produces a major infusion of homeownership units for a distressed neighborhood may be able to change the neighborhood's character. On the other, a program that concentrates a large number of additional low-income households in an already-built neighborhood may have a negative effect, especially if many of those households have trouble retaining their homes.¹¹

Empirical analysis of the effect of homeownership programs on neighborhoods has just begun. Important new analysis by Ellen, Schill, and others found that subsidized new construction of homeownership units in distressed neighborhoods in New York City in the 1980s and 1990s had a positive effect on property values in the immediate vicinity of the subsidized units. This is the first study to find such an effect, and the authors are quite cautious in the interpretation of their findings.¹²

Thus, it is quite possible for a program to have either no neighborhood effect or a negative effect. Careful analysis of housing market and other trends in the target neighborhood may increase the chance of positive effects. However, this analysis must be done locally and cannot be achieved by uniform rules designating eligible areas for a national program, regardless of whether those rules are based on average income or on some other criteria.

In addition to neighborhood revitalization, a homeownership program may have another location-specific objective. The program may make it possible for households with low or moderate incomes to live in areas they would not otherwise be able to afford. Using Home Mortgage Disclosure Act (HMDA) data, Duda and Belsky find sharp increases in the 1990s in home buying by low-income and minority households both in the suburbs and outside low-income census tracts. However, they point out that the pattern varies sharply by metropolitan areas and cite studies that document the high levels of segregation by race for this home buying in some metropolitan areas.¹³

Harkness and Newman find a positive effect of homeownership on the children of low-income families, attributable in part to the greater stability of owned housing compared with rental housing. However, they conclude that when low-income families are homeowners in distressed neighborhoods, the positive effects of homeownership are weakened substantially.¹⁴ Thus, this study provides support for program designs that encourage home buying *outside* low-income neighborhoods.

¹¹ Recall the history of HUD's Section 235 program, in which foreclosures were concentrated in specific neighborhoods, creating vacant properties that added to neighborhood distress.

¹² Ingrid Gould Ellen, Michael H. Schill, Scott Susin, and Amy Ellen Schwartz, "Building Homes, Reviving Neighborhoods: Spillovers from subsidized Construction of Owner-Occupied Housing in New York City.," Forthcoming in *Journal of Housing Research*. Draft dated July 18, 2001. The authors cite an unpublished paper by Jean Cummings, Denise DiPasquale, and Matthew Kahn that found no spillover effects from two developments in Philadelphia that produced new homeownership housing under the Nehemiah program.

¹³ *Op.Cit.*, pp.16-19.

¹⁴ Joseph Harkness and Sandra J. Newman, "Homeownership for the Poor in Distressed Neighborhoods: Does This Make Sense?" Institute for Policy Studies, Johns Hopkins University, December 2001.

If the objective of a homeownership program is to make better housing locations available for low-income and minority households, the fact that the household would have become a homeowner anyway, but in a less desirable location, may not be a drawback. It also may not be important to restrict such a program to first-time buyers. However, it could be difficult to design national rules that determine those areas not already affordable to low-income households. For example, housing at the growth perimeter of a metropolitan area might or might not be affordable for households with incomes below 80 percent of median, depending on patterns of growth and land prices in the particular metropolitan area. In addition, without careful outreach, such a program could well reach mainly those income-eligible buyers who would have sought housing in the target location in any case.

4. The extent of program efficiencies created by transaction and monitoring costs and the nature of the subsidy.

Program costs may be thought of as the difference between the cost to the government of the program and the benefits received by the borrower or surrounding property owners in the form of direct subsidy or spillover effects. Thus, program costs include transaction costs, monitoring costs, and the cost of subsidies not captured by borrowers (such as development subsidies not reflected in lower costs to the homebuyer). The costs of subsidizing individual homeowners may differ among program approaches. In general, demand-side subsidies based on housing available in the market have lower costs than supply-side approaches that cover costs of new construction or rehabilitation. However, supply-side programs may have other objectives, besides enabling individual households to become homeowners or improve their housing circumstances.

Any homeownership subsidy that is not delivered directly to the consumer will be absorbed to some extent by the entity through which the subsidy passes to the consumer. For a syndicated tax credit—one that is sold to third-party investors in the likely event that it cannot be used by the developer or lender to whom it has been allocated—there will also be costs associated with compensating investors for risks and providing them a competitive rate of return. Finally, a program with extensive needs for monitoring and compliance systems will channel program resources to administrative costs rather than to households.

1.2 Summary of Strengths and Weaknesses

Table 2 summarizes our assessment of the strengths and weaknesses of the four program models. Three of the four—the Single Family Homeownership Tax Credit, the Mortgage Subsidy Tax Credit, and the Flexible Tax Credit—would face the transactions costs associated with syndication. However, syndication costs would be lower for the lender-based Mortgage Subsidy Tax Credit than for the developer-based Single Family Homeownership Tax Credit, because the product would be more standardized and the risks associated with buying it would be lower and easier to understand.

By far the largest advantage enjoyed by the Mortgage Subsidy Tax Credit is that it is a demand-side program based on existing housing units. Unlike the Single Family Homeownership Tax Credit, it does not have to cover the cost of developing new or substantially rehabilitated units.

In addition, the Mortgage Subsidy Tax Credit would be able to address all of the major barriers to homeownership, while a Single Family Homeownership Tax Credit would not. Furthermore, a program that does not target specific housing units selected by a developer has less risk of negative neighborhood effects.

Neither the Single Family Homeownership Tax Credit nor a Mortgage Subsidy Tax Credit targets only those households with the greatest likelihood to have long-term barriers to homeownership. Income limits at the 80 percent of median level would include many households likely to become homeowners without subsidy. However, either program would be more successful at reaching households otherwise unlikely to become homeowners if it were designed so that community-based non-profits helped target the subsidy. Their outreach mechanisms and knowledge of local housing markets make community-based non-profits more likely than developers or lenders to reach the most marginal among potential homebuyers.

In addition, both the Single Family Homeownership Tax Credit and a Mortgage Subsidy Tax Credit could be improved through an allocation formula that focuses program resources on states with the problems they are designed to address. For the Single Family Homeownership Tax Credit, this would be states that have substantial population living in older urban areas with distressed neighborhoods or, if the program were redesigned so that it also helped low-income and minority households reach portions of metropolitan areas with economic opportunities, states with high poverty rates and growing populations. A Mortgage Subsidy Tax Credit could be allocated based on state lags in homeownership rates compared with the national average or, to focus the program on barriers to homeownership other than income and wealth, to states with lower than expected homeownership rates given their demographic characteristics.

A First Time Buyer Tax Credit is very appealing because of its low transaction costs and because it addresses the wealth barrier to homeownership. An entitlement version of such a program, available by right to any taxpayer meeting broad eligibility criteria, would be expensive. While it would be possible to design an allocation scheme to ration the credit and to target it to those households most likely to have barriers to becoming homeowners, selection of certain households to receive a direct tax benefit might be particularly vulnerable to an appearance of unfairness. In addition, experience with the Earned Income Tax Credit suggests that, even if tax credits are refundable and can be used by households without tax liability, extensive outreach is needed to reach the households that need the credit the most. Such outreach might make it more difficult to ration the credit. We conclude that a consumer-based First Time Buyer Tax Credit would need to be an entitlement, like most tax credits or deductions, with costs controlled by categorical rules for determining which taxpayers are eligible or by providing the credit each year on a first-come first-served basis.

The Flexible Tax Credit is intended to devolve to the state level the decision on whether to use a Single Family Homeownership Tax Credit or a Mortgage Subsidy Tax Credit. States would have the ability to use a developer-based tax credit in housing market areas that have shortages of affordable units or “appraisal gaps” that make it difficult to build in low-income neighborhoods. However, the weaknesses of a developer-based tax credit would not disappear if the decision to use such a credit were made on the state rather than the federal level. The Flexible Tax Credit does not really have the character of a block grant, in which a state or local administrator can

tailor the design of the subsidy to the needs of a particular neighborhood. It may be that tax credits cannot have this degree of flexibility. Tax credits must have a uniform design so that compliance with their rules can be monitored by investors and the IRS and so that they can be priced efficiently.

Table 2: Strengths and Weaknesses of the Four Models

Key: + meets criterion
 - fails to meet criterion
 ? ambiguous

	Removes Barriers to Homeownership	Targets Only Those Households with Barriers	Avoids Negative Neighborhood Effects	Has Minimal Inefficiencies
Single Family Homeownership Tax Credit	-	-	?	-
Mortgage Subsidy Tax Credit	+	?	+	+
First Time Buyer Tax Credit	+	-	+	+
Flexible Tax Credit	?	-	?	-

II. Detailed Assessment of Program Models

This section discusses each of the four program models in more detail. For each model, we discuss the strengths and weaknesses of the program design and suggest specific program features that might mitigate the weaknesses of the approach and enhance its strengths

2.1 Single Family Homeownership Tax Credit

The Bush Administration's proposal is designed to parallel the Low Income Housing Tax Credit (LIHTC) for rental housing. The proposal channels a credit through developers who build or rehabilitate affordable homes for qualified buyers. Housing units must be sold to households with income below 80 percent of the area's median family income (70 percent for households with fewer than three members).

The program provides a tax credit to the developer for up to half the cost of development of the housing unit. Draft legislative language produced by a housing industry group adds a constraint that the tax credit cannot exceed the difference between the development cost and a lower appraised value of the unit. Therefore, unless combined with another subsidy, this program will not be able to provide a below-market sales price.

The program may be used only in census tracts with median incomes at 80 percent or less of area median income.

The allocation process would follow the LIHTC model: states would receive a capped allocation based on a specified dollar amount per capita. State allocating agencies would distribute credits to qualified developers who would either use the tax credits directly or sell them through a syndicator. Tax credit investors would own the housing units during the construction period and then would be permitted to take the tax credit over a period of five years beginning with the year in which the housing unit was sold to a qualified buyer.

The Administration's program description includes a provision that would recapture the value of the tax credit from the homebuyer when a household no longer within the program's income limit resold a housing unit to another household not within the program's income limit. The amount of recapture would phase out over three years and would be limited to 80 percent of the gain in value of the house.

2.1.1 Strengths and Weaknesses of a Single Family Homeownership Tax Credit

The Single Family Homeownership Tax Credit does not hold up well against the evaluation criteria outlined earlier.

Barriers to Homeownership

It would do little to address barriers to homeownership among low-income households. Only if the program produced additional units of housing in a market area where very few housing units—new or existing—were affordable for households with incomes below 80 percent of median would it help households overcome an income constraint. While only a modest number of *newly built* units are affordable for households at that income level, especially if one excludes manufactured housing, 44 percent of *all* owner-occupied units were affordable for households at that income level in 1999 (39 percent excluding mobile homes).¹⁵ If one assumes that households would use an “affordable” mortgage product, the share of affordable units rises to 52 percent. Furthermore, these estimates do not take into account the ability to convert some rental housing units to homeownership.

There are sharp differences in affordability levels by region of the country, with the West having the lowest share of affordable units, 34 percent. Homeownership rates for low-income households vary a great deal among metropolitan areas.¹⁶ But experience with programs that subsidize the production of rental housing demonstrates that it is very difficult to focus a national program on geographic areas with relative shortages.¹⁷

Within metropolitan areas, there clearly are large affordability barriers in many individual jurisdictions and neighborhoods.¹⁸ However, the program’s focus on *low-income* neighborhoods (those with median incomes below 80 percent of median and with a gap between development costs and appraised value) would preclude it from building affordable homeownership units in those locations within metropolitan areas most likely to have affordability gaps.

Even if it were to overcome income barriers to homeownership in some locations, the Single Family Homeownership Tax Credit would do little to address wealth constraints and nothing to address credit constraints. The program’s main potential benefit to households would be to increase the quality of housing occupied by those who would have become homeowners in any case. This quality increase might be increased size or additional amenities of units in low-income neighborhoods.

¹⁵ Michael Collins, David Crowe, and Michael Carliner, “Examining Supply -Side Constraints to Low-Income Homeownership,” Joint Center for Housing Studies of Harvard University, Low-Income Homeownership Working Paper Series, August 2001.

¹⁶ Kathryn P. Nelson, “Housing Needs and Effective Policies in High-Tech Metropolitan Economies,” *Housing Policy Debate*, forthcoming 2002

¹⁷ The short-lived Housing Development Grant (HoDAG) program attempted to do so in the late 1980s. Congress insisted on broadening the list of eligible areas originally proposed by HUD.

¹⁸ Duda and Belsky, *Op.Cit.*

Targeting to Households with Barriers

The program is very likely to be used by households likely to become homeowners in any case. The sales price must be affordable for low-income households, but this would also be the case for the other housing units with the same price on which the appraisal of the market value of the program units was based.

An indication that this program is not intended to increase the number of low-income homeowners is that eligibility for the program is not limited to first-time homebuyers.

Neighborhood Effect

Neighborhood revitalization is the real purpose of this program, which is designed to overcome the “appraisal gap” that exists in specific neighborhoods. The sales price of housing in those neighborhoods is too low to cover the cost of new construction, and the value of existing units is too low to motivate their owners to invest in improvements.

Since the Single Family Homeownership Tax Credit subsidizes only the difference between construction cost and appraised value, the appraised value must be affordable for households with incomes below 80 percent of median. Therefore, the credit probably would be used predominantly in modest neighborhoods even without an explicit legislative mandate to do so.

The program would almost certainly favor large-scale developments to increase the efficiency of syndicating and selling the tax credit. Therefore, the program could very well concentrate production in particular neighborhoods. The effect of new housing production in target neighborhoods is unclear. In extremely distressed neighborhoods characterized by severe substandardness, abandonment, and vacant land, the program—if on sufficient scale—might create a new or transformed neighborhood. This is the Nehemiah model created in the 1980s, which only rarely produced housing on the scale needed to achieve neighborhood transformation.¹⁹

A particularly difficult challenge for this program would be to avoid “gentrifying” neighborhoods in which the effect of the program could be add to price increases that were already occurring in the absence of the program. This is most likely to occur if large homeownership subsidies are concentrated in a small geographic area where there are barriers to increased production (e.g., little buildable land and few units in badly deteriorated condition that might be rehabilitated). In such neighborhoods, the tax credit might be used to build housing on land that is already increasing in value.

¹⁹ Anthony Phipps, Kathleen Heintz, and Monte Franke, *Evaluation of the Nehemiah Housing Opportunity Program*, Abt Associates Inc., 1994. The New York City Nehemiah program on which the national Nehemiah program was modeled did produce housing on such a scale. The study cited earlier by Ellen, Schill, and others found positive neighborhood impact from the New York Nehemiah program, but not “transformation.”

In neighborhoods with rising house prices, infill production or scattered rehabilitation funded by this program might, in combination with resale restrictions, maintain housing opportunities for low-income households. However, such an objective could also be achieved by subsidizing—at lower cost—the purchase of existing housing in the same neighborhoods.

If there were no legislative restriction on the location of eligible housing, the program could be used to create mixed-income housing in higher-value neighborhoods. This would be achieved by including in a market-rate subdivision some smaller units with fewer amenities that would have an appraised value (and sales price) below their construction cost. However, the opportunity to pad development costs might be particularly great when the program was used in that way as developers could allocate costs associated with more expensive units to the more affordable units.

Efficiency

The program is inefficient by its very design. The benefit to the homeowner is the opportunity to occupy a newly developed housing unit. However, because the program subsidizes the difference between the development cost and appraised value, in the absence of another source of subsidy *the homeowner will pay the market value of the unit*. None of the cost of the subsidy will be passed through to the homeowner, unless the program creates an increase in the value of neighborhood housing²⁰ or the program is used in an already-gentrifying neighborhood. Furthermore, the program's recapture provisions appear to be designed to limit the amount of subsidy that can be passed through to upwardly mobile homeowners in neighborhoods experiencing increases in value.

The design of the program might be modified to permit the tax credit to pay for a sales price write-down as well as filling the gap between development cost and appraised value. This would provide part of the benefit to the homebuyer, but the basic inefficiency of the program (subsidizing construction costs above value) would remain, and the program would become more expensive.

Developers would have an incentive to increase total development costs in order to increase the difference between the development cost and the appraised value of the unit. Cost increases could add to the quality of the housing unit, or they could simply be excess costs for producing housing of the same quality. For example, higher quality finishes and appliances would add to both the cost and the quality of the housing units. Excess costs compared with quality could come about through the way in which costs were allocated across subsidized and unsubsidized units, if combined in the same development, or through sweetheart deals between developers and their suppliers. Costs would be controlled only modestly by the limit of the tax credit to 50 percent of development cost. The competitive process for allocating the tax credit to developers might also help to control costs, but total development cost is likely to be only one of a number of competitive factors.

²⁰ The study cited earlier by Ellen, Schill, and others found positive impact on neighborhood house values from the New York Nehemiah program, but these increases in value were quite modest.

In addition to the incentive to increase development costs, the costs associated with syndicating and selling a Single Family Homeownership Tax Credit and providing a competitive rate of return for investors would be high, for the following reasons.

There are risks associated with any investment that has a specified rate of return and that is dependent on the investor's tax situation. These risks are greater when the investor takes the tax credit over several years instead of in a single year. It is difficult to assess the design of the Single Family Homeownership Tax Credit in this respect, especially since the Bush proposal and the industry draft appear to differ concerning the tax credit period.

To diversify risk adequately for investors, syndicators would likely pool the tax credit properties produced by individual developers. It could be complex (and, therefore, expensive) to pool the risk associated with investing in construction period ownership of single-family properties subject to a variety of market conditions as well as requirements for program compliance. While the Single Family Homeownership Tax Credit parallels the LIHTC in some respects, little of the knowledge gained about the performance of LIHTC investments would be transferable to the single family credit.

Particular risks that appear to be associated with the Single Family Homeownership Tax Credit are:

1. the risk that the appraised value of the housing unit will be higher than anticipated, and, therefore, the value of the tax credit will be lower;
2. the risk that the units will not be salable at appraised value (the unit must be sold to an income-qualifying household within a year of the certificate of occupancy); and
3. the risk that the tax credit will be recaptured because of non-compliance through sale to an unqualified buyer.

It is not clear from draft legislative language produced to date whether the tax credit investors are responsible for enforcing the provisions that require recapture of the subsidy from the homebuyer under certain circumstances or what the mechanism for such recaptures would be. It is also not clear whether tax credit investors are at risk in the event that the homebuyer loses the unit through foreclosure. If the investor's risks continue beyond the sale of the unit to the first qualified buyer, the yield of the tax credit will be lower because risks will be higher and because risks will be more difficult to assess. Furthermore, the role of the syndicator in monitoring compliance on behalf of the investor will continue for a longer time, increasing the cost of syndication.

2.1.2 Design Features That Could Improve the Single Family Homeownership Tax Credit

While we believe the design of the Single Family Homeownership Tax Credit is inferior to other possible low-income homeownership programs, there are ways in which the program might be improved.

Reaching households with real barriers to homeownership

One approach would be to include in the statutory framework a requirement that eligible housing (or a very large fraction) must have been developed by a partnership that includes a community-based non-

profit or a fair housing counseling agency.²¹ Such organizations can reach households that would not have become homeowners otherwise. By using their local knowledge and access, community-based non-profits and fair housing groups could market the program to those recipients not likely to be on the threshold of substantial income growth and to minorities who may have barriers other than income to becoming homeowners. Participation by socially motivated non-profit organizations might help control “padding” of development costs that does not add to the quality of the housing produced. Community-based non-profits also would also be in an excellent position to focus the program on those neighborhoods most likely to benefit from increased homeownership or to be truly unreachable by unsubsidized low and moderate- income homebuyers.

There are precedents for set-asides for non-profits in the Low Income Housing Tax Credit and HOME, and both programs have well-established regulatory frameworks for defining entities that qualify as non-profits. In both cases, the requirement is limited to a modest percent of the program. In the case of HOME, 15 percent of the program is directed to community development housing organizations (CHDOs). For the LIHTC, states are required to allocate 10 percent of the tax credit to developers with a non-profit partner, although many states go beyond this in their qualified allocation plans (QAPs). One of the current proposals for a developer-based homeownership tax credit (Torcelli, S.1081) has a set-aside for non-profits, but it is very small (10 percent).

Another approach for targeting the program to households with real barriers to homeownership would be a requirement that eligible purchasers must have been through a program of homeownership counseling that includes features such as financial management and credit repair. Such counseling programs, as contrasted with programs that make homebuyer education a requirement for already-qualified borrowers to complete a home purchase, reach households with significant barriers to qualifying for a mortgage.

The program might treat counseling as an eligible development cost or might make counseling a mandated use of fees charged to developers by the allocating agency. Because of the substantial benefits created by the program for developers, they are likely to be willing to pay such fees in order to obtain a tax credit allocation.

Yet another way of reaching households unlikely to become homeowners without assistance would be limiting eligible households to those using homeownership vouchers, receiving downpayment assistance from a state or local program (using HOME, CDBG, or another funding source), or using the proceeds of an Individual Development Account (IDA) in which household savings are matched by a public or private program. The other programs identified here often operate in partnership with community-based non-profits²² and often have outreach approaches that make them likely to serve households with real barriers to homeownership.

²¹ Fair housing groups would be particularly important if the program had an income-mixing objective. They might be defined as agencies for which a central purpose is helping low-income and minority families to locate housing near employment centers.

²² IDAs funded under the Assets for Independence Act are awarded by the Department of Health and Human Services to non-profit organizations, public agencies partnering with non-profit organizations, low-income credit unions, and community development financial institutions.

Because the Single Family Homeownership Tax Credit does not subsidize the costs of homeownership from the household's point of view, its combination with another program would not be redundant.²³ Instead, this combination would insure that income and, especially, wealth constraints were removed for participating households.

A much more indirect approach would be to require a sub-allocation system based on an analysis of barriers to homeownership for particular demographic and income groups and geographic locations. Applicants in a competition for the tax credit would have to demonstrate that the housing they develop would overcome the specific barriers identified. This is similar to the qualified allocation plan (QAP) requirement of the Low Income Housing Tax Credit, but experience with that program suggests that the requirements would have to be quite explicit and not easily offset by competing priorities in the statutory language that mandates the QAP.²⁴

Matching the allocation formula to the purpose of the program

Because the SFHTC is designed to revitalize neighborhoods rather than to create new homeowners, its formula should provide more resources to states in which a relatively large portion of the population lives in older urban neighborhoods or in cities with high levels of distress.²⁵ For example, the census-based factors that comprise CDBG formula B would do this. The formula B factors are pre-1940 housing (weighted at .5), poverty (weighted at .3), and "growth lag" (weighted at .2). Growth lag is the difference between the actual rate of population growth and the rate of growth experienced by all areas since 1960. The use of the CDBG formula B factors would heavily favor older Northeastern and Midwestern cities and their states.

If the purpose of the program is not just neighborhood revitalization, but the program is also intended to help low-income families access otherwise unaffordable neighborhoods, then the dual CDBG formula might be more appropriate, with each state receiving the higher of the two formula amounts. CDBG formula A includes poverty (weighted at .5), population (weighted at .25), and overcrowded housing (weighted at .25) and would tend to favor states with growing cities in the South and West.

Adjusting the income limit for household size

The program as proposed has only two income limits for each geographic area, one for one or two person households (70 percent of median income), and the other for households with three or more members (80 percent of median). It would be highly desirable to provide a higher limit for households with more than three members in order to increase the likelihood that families with children will use the program. Nelson documents that ownership rates among low and moderate-income families with children have lagged, even as the ownership rates of other types of households have increased.²⁶ The additional residential stability associated with homeownership

²³ This would no longer be the case if a sales price write-down funded by the tax credit were added to the program.

²⁴ National Low Income Housing Coalition, "Qualified Allocation Plans for the Federal Low Income Housing Tax Credit Program: An Analysis of Income Targeting," February 2001.

²⁵ This discussion assumes that the first level of allocation of a tax credit or other homeownership subsidy is to states only.

²⁶ Kathryn P. Nelson, *Op.Cit.*

may be especially important for children.²⁷ At the same time, families with children or other dependents may find it more difficult to increase their incomes through changing jobs or increasing hours worked. Fewer families with children and low incomes than single persons or childless couples are likely to be at the entry level of a steep upward progression in earnings.

2.2 Mortgage Subsidy Tax Credit

A Mortgage Subsidy Tax Credit would be a lender-based, demand-side program that provides one or more forms of mortgage subsidy to low-income first-time buyers of the home of their choice. Lenders or private mortgage insurers would receive the tax credit from state allocating agencies through a competitive process. They could use the credit to offset their taxable income or could sell it to investors directly or with the assistance of syndicators. State allocating agencies would design a program to include one or more of the following financial products to be owned in association with the tax credit:

- a below-market interest rate first mortgage;
- a below-market interest rate second mortgage; or
- a mortgage insurance contract with a below-market premium.

The tax credit would be allocated to states through a capped formula.

The state-level allocating agency would compare the size of the subsidy per dollar of credit offered by each participant in the competition—for example, the reduction of the interest rate below market levels for a first mortgage with otherwise similar characteristics.

Below market interest rate mortgages made with the proceeds of tax credits should be designed to remain in effect only until the housing unit was sold or the mortgage refinanced. The loss of the subsidy upon sale or refinancing would constitute a substantial prepayment penalty. Such a penalty would reduce the risk to investors that mortgages would be prepaid at a time of falling interest rates and, therefore, reduce the interest rate of mortgages that investors were willing to buy.²⁸ One study has estimated that more than 60 basis points are necessary to cover lenders'

²⁷ Newman and Harkness, *Op.Cit.*

²⁸ It might also be desirable to prohibit assumption of the below-market mortgage by a new borrower for the same housing unit, for two reasons: 1) Non-assumability would eliminate some of the risk associated with possible increases in market interest rates during the life of the mortgage (extension risk); and 2) If mortgages were assumable, this would add a requirement for monitoring the eligibility of the subsequent borrower.

prepayment risk.²⁹ Thus, if the prepayment risk were reduced by half, investors might provide a further reduction of 30 basis points in the interest rate.³⁰

First and Second Mortgages

Two current proposals for subsidizing homeownership rely on a lender-based credit. One would use a tax credit to subsidize first mortgages, the other to subsidize second mortgages. Neither includes an option for subsidized mortgage insurance.

Mortgage Guaranty Insurance Corporation (MGIC) has circulated a proposal for a tax credit for lenders to make low-interest **first mortgages** to first time buyers with incomes below 80 percent of area median income, fully adjusted for household size. The interest rate buy-down would take the form of prepaid interest (points), typically 10 to 20 percent of the house price. The lender or other owner of the mortgage would receive the tax credit in the quarter or year in which the below-market loan was made, but the lender could defer taking the credit or sell the tax credit to another investor during a period of up to three years.

The most recent version of the MGIC proposal (November 2001) would provide a maximum subsidy of \$25,000 for households with 70 percent or less of area median income and \$10,000 for households with higher incomes. Income limits could exceed 80 percent of area median in “HUD targeted zones” to attract relatively higher income households to distressed neighborhoods.

This proposal could be structured so that a first mortgage covered downpayment and most closing costs as well as providing an interest subsidy.

Legislation introduced by Congresswoman Roybal-Allard (D-CA) would create a lender-based tax credit to subsidize **second mortgage loans**. In addition to providing a below-market interest rate, these second mortgages would cover closing costs and down payments. The amount of the mortgage would be between 18 and 22 percent of the appraised value of the home, and the interest rate would be three percent or less. Homebuyers at or below 80 percent of area median income, fully adjusted for household size, would qualify and would have to provide a downpayment of the lesser of two percent of the purchase price or \$1000. Homebuyers at or below 50 percent of area median income also would be permitted to obtain Mortgage Revenue Bond financing for the first mortgage.³¹

It appears that these second mortgages are intended either to have a below-market interest rate or to be zero-interest loans with a balloon payment of principal. The lender or ultimate owner of the

²⁹ Peter Chinloy and Isaac Megbolugbe, “Hedonic Mortgages,” *Journal of Housing Research*, 5:1, 1994, pp.1-21.

³⁰ Wayne R. Archer, David Ling, and Gary McGill find that lower income borrowers are no less responsive than higher income households to incentives to prepay created by changes in interest rates and conclude that there is “no evidence that the price ‘charged’ by lenders for the embedded call option should be different for lower income borrowers.” “Prepayment Risk and Lower Income Borrowers,” Joint Center for Housing Studies of Harvard University, Low-Income Homeownership Working Paper Series, September 2001, p.34.

³¹ This program is further elaborated in J. Michael Collins, Eric Belsky, and Nicolas P. Retsinas, “Toward a Targeted Homeownership Tax Credit,” Brookings, January 1999. The authors base their case for second mortgages in part on the importance of wealth constraints to home buying among low-income households.

mortgage would receive the tax credit over 10 years, the below market interest (if any), and repayment of principal.

From the standpoint of both the homebuyer and the agency that allocates the credit, these proposals for first or second mortgages are more similar than they might at first appear. A subsidized second mortgage, by reducing the loan-to-value ratio (LTV) on the first mortgage, would eliminate the requirement for credit enhancement (such as mortgage insurance) that is imposed by law on Fannie Mae and Freddie Mac purchases of loans with LTVs above 80 percent. This would appear to make the cost to the homebuyer—and the amount of subsidy needed to achieve affordability for a particular homebuyer—lower. However, the higher risk associated with mortgages that have a high effective LTV (taking first and second mortgages into account) would be reflected in the price investors were willing to pay for the second mortgage.³² The higher risk might affect the pricing of the first mortgage as well. The same homebuyer could be subsidized by a particular amount of tax credit to virtually the same extent by taking a subsidized first mortgage (with a lower interest rate per dollar of tax credit) and mortgage insurance.³³

Deep Mortgage Insurance

An alternative way to deliver a subsidy is through mortgage insurance (MI). The tax credit would be allocated to private mortgage insurers (PMIs), who would use the credit in association with a “deep MI” insurance contract with a below-market premium. Unlike standard mortgage insurance, which covers the top 15 to 30 percent of the mortgage balance, deep MI would cover at least 50 percent of the mortgage balance. PMIs would either use the tax credit to offset their own tax liability or sell both the insurance contract and the associated tax credit to lenders, who might use the insurance to support lending that meets Community Reinvestment Act (CRA) standards.

Deep MI typically is used for loans small in size³⁴ or for loans viewed as having high risks of foreclosure. Such loans are likely made to borrowers who are the most marginal – i.e., those least likely to buy without some form of assistance. In effect, the distributors of the subsidy would be reaching into the sub-prime market, paying for the additional risk associated with some low-income potential homebuyers. The subsidy would be funded by a tax credit instead of the above market interest rates or other costs to the borrower typically associated with sub-prime lending.

³² Second mortgages currently used to eliminate the need for mortgage insurance have interest rates *above* the market rate for first mortgages.

³³ In most cases, there would be no difference in the income tax paid by the homeowner, since most low-income homeowners do not itemize deductions.

³⁴ Because of the fixed costs of foreclosure, loss percentages are higher for smaller loans.

2.2.1 Strengths and Weaknesses of a Mortgage Subsidy Tax Credit

A demand-side tax credit delivered through lending institutions in the form of a subsidized mortgage and, in some cases, mortgage insurance would have the following advantages and disadvantages:

Barriers to homeownership

A Mortgage Subsidy Tax Credit as we have described it would address all three barriers to homeownership among low- income households: income, wealth, and credit.

Targeting to households with barriers

Since eligibility is only limited to first time buyers with low incomes, without any consideration of other barriers to homeownership, there is considerable risk that the program would be used by households that would have become homeowners shortly in any case. However, this risk would be lower for some potential uses of the tax credit. For example, deep mortgage insurance would in some sense be self-targeting, as households without credit barriers would see little or no benefit from deep MI. If the program were used for deferred payment second mortgages or the size of the subsidy varied steeply with income (perhaps even more so than in the MGIC proposal), it would have the potential for reaching households with considerable income and wealth constraints.

Neighborhood Effect

Without an explicit requirement for neighborhood targeting, a demand-side program would have modest neighborhood effects. It could induce some homebuyers to choose housing in somewhat higher cost neighborhoods than they otherwise could afford. At the same time, the program's income limits and the remaining income constraints for low-income buyers would direct most of the home purchases to low-income neighborhoods. However, the difficulty of targeting for particular purposes or the danger of over-concentrating subsidies in particular neighborhoods would not be present.

With no income limit in certain neighborhoods to be defined by HUD, the MGIC proposal is intended to attract relatively higher income households—those with incomes greater than 80 percent of area median income—to those locations. Whether this feature would have any effect at all, or whether it might add to price appreciation in already-gentrifying neighborhoods, would depend on how the target neighborhoods were defined and selected. As already noted, it is extremely difficult for uniform federal rules to select neighborhoods well.

Efficiency

The largest efficiency advantage for a demand-side subsidy stems from the fact that it does not need to cover the above-market costs of producing new housing. A supply-side program, based on newly developed housing, would have to pay a substantial portion of the cost of that development. A demand-side program would be able to overcome much smaller barriers to the purchase of existing units.

A Mortgage Subsidy Tax Credit would have the inefficiencies associated with any program in which tax credits are pooled and sold along with an investment product. A rate of return must be provided that is commensurate with the risks associated with investing in a tax benefit.³⁵ In addition, the packaging and sale of the tax credit and associated mortgage products to investors other than the originators of loans and providers of mortgage insurance would create transaction costs.

However, syndication costs are likely to be lower for a lender-based tax credit than for a developer-based tax credit because mortgage terms are fewer and far more standardized than the factors that go into the development cost of a house. The terms of a mortgage or of deep mortgage insurance made through this program also could easily be compared with the market prices for these products, so the amount of the subsidy flowing through to the homebuyer would be clearly understood by the allocating agencies. It would be much easier to assess whether the amount of subsidy proposed was reasonable than to assess the total development cost actually needed to build new units. In addition, lenders receiving the tax credit might be able to sell it as part of a package with the first or second mortgage to other lending institutions, including government sponsored enterprises and federal home loan banks, without the additional transaction costs of using syndicators.

An advantage of the first mortgage approach is the larger individual size of the loans, which would make it easier to pool them efficiently. A well-developed secondary market for below-market second mortgages does not currently exist. For the development of a secondary market, aggregate information on loan performance would be needed to allow investors to accurately gauge and model the risk of these loans. This information would be collected by allocating agencies and then made available to potential investors.³⁶ With a database of performance and familiar loan terms, investors might eventually enter a secondary market for second mortgages, but it might take time and transaction costs could be high. We recommend leaving this judgment to allocating agencies. Lenders in some states may have more facility than others in dealing with the nascent secondary market for second mortgages.

State housing finance agencies (HFAs) would be the likely state allocators of the tax credit. Because HFAs are themselves owners of mortgages, there would need to be a program requirement prohibiting non-competitive allocation of tax credits to be sold in association with HFA mortgages.³⁷

2.2.2 Design Features That Would Improve a Mortgage Subsidy Tax Credit

Reaching households with real barriers to homeownership

³⁵ The MGIC proposal adds the risk that the tax credit will be recaptured if a loan reaches 90-day delinquency within 12 months of origination and ultimately result in a loss of homeownership. The Roybal-Allard proposal adds the risk that the tax credit is taken over a ten-year period and ceases if the mortgage is repaid during that time.

³⁶ It should be a requirement of the program that data on the performance of mortgages funded by the tax credit be made publicly available in order to foster the creation of a secondary market.

³⁷ The study by Collins, Belsky, and Retsinas cited earlier appears to handle this in a design for a mortgage subsidy tax credit by requiring HFAs to sell the credit at auction to “third party investors” who would be the originators of mortgages.

One approach to increasing the extent to which households with real barriers to homeownership used the limited allocation of tax credits would be to base the state agency sub-allocation in part on an analysis of barriers to homeownership for particular income or demographic groups and locations within a state. However, competitions that included factors other than the price of the mortgage product would be less transparent and would make the program somewhat less efficient.³⁸ This is a trade-off against the advantages gained from targeting the program to the right households.

We do not recommend legislative language that restricts the use of a Mortgage Subsidy Tax Credit to particular neighborhoods defined by law or regulation. It is better for assessments of neighborhoods that can benefit from additional homeownership—or of neighborhoods that should be targets for increased accessibility for low-income households—to be conducted by those familiar with local housing market conditions.

In addition to a competition based on proposals that specified target households and neighborhoods, there might be an explicit requirement for a competitive advantage to partnerships that include both lenders (or mortgage insurers) and community development organizations. Just as is the case for a supply-side tax credit, the involvement of community-based non-profits and fair housing organizations would help a Mortgage Subsidy Tax Credit reach households with real barriers to becoming homeowners.

Allocation of the tax credit to non-profits who would *subsequently* sell the credits to financial institutions would not work. In order to base a competition at least in part on the price of the mortgage product, a lender or mortgage insurer would have to be part of the proposal to the allocating agency.

Another desirable program feature would be to limit eligibility to households that have gone through a counseling program that includes financial management training and credit repair.

Both Roybal-Allard and the MGIC proposal have counseling requirements, but they are not detailed. MGIC has discussed the possibility of allowing non-profit agencies to recover the cost of providing counseling services at a capped amount through a lump-sum charge that would be financed as part of the loan amount. However, a problem with funding counseling in this way is that it does not compensate the counseling agency for working with marginal potential homebuyers who do not become homebuyers or buy only after a considerable period.

Another possibility for funding counseling associated with a lender-based program is for a larger appropriation of counseling funds allocated by HUD, with a requirement that funded counseling be used in connection with the mortgage subsidy tax credit.

³⁸ The MGIC proposal does not base the competition on price alone, but on a combination of the amount of subsidy proposed and the historic performance of the applicant along two dimensions: use of the full amount of tax credit authority allocated and the performance of tax credit loans. The latter criterion might make tax credit lenders less willing to use the program for households with real barriers to homeownership.

Because there would be smaller potential profit margins for participants in a demand-side program than for a developer-based tax credit, it may not be realistic to propose funding counseling through fees charged to tax credit users by state allocating agencies.

We do not recommend that a Mortgage Subsidy Tax Credit include a provision for recapturing the subsidy from homebuyers whose houses values appreciate and who sell in the first few years after buying. While such provisions can help discourage use of the program by households who could afford to buy without the subsidy, they would add to the responsibilities of the lender or, potentially, the tax credit syndicator and reduce the efficiency of the program.³⁹

Matching the allocation formula to the purpose of the program

This program is not tied fundamentally to neighborhood revitalization but intended more generally to serve those most likely to be unable to afford homeownership without a subsidy. It would be desirable to allocate the subsidy based on a measure of the “homeownership gap” in each state. For example, it would be very easy to measure the extent to which the homeownership rate for a state lags the national homeownership rate and to adjust a per capita allocation by an index that compares state rates to the national average. This would likely tilt the program toward relatively urbanized states and toward states with high proportions of racial and ethnic minorities,⁴⁰ but without a strong emphasis on the Northeast and Midwest.⁴¹

A more sophisticated formula approach, intended to focus on barriers to homeownership *other than income*, would instead use an index of the extent to which the homeownership rate in a state lags the rate that would be expected, given the distributions of income, age, and household type in that state. Techniques for modeling expected homeownership rates have already been developed.

2.3 First-Time Buyer Tax Credit

A proposal introduced by Congressman English would provide a tax credit to first-time homebuyers regardless of income or location. This tax credit could be used directly by any first-time buyer against personal income tax liability for the year in which the home was purchased. The amount of the credit would be 10 percent of the sales price, up to \$6,500. A similar tax

³⁹ The Roybal-Allard bill introduced on May 25, 2001 (H.R. 2033) includes a recapture provision that may not apply very often. A mortgagor with family income at or greater than 115 percent of area median income who sells within ten years to a buyer who does not assume the qualified homeownership loan must repay (through an income tax increase) 50 percent of the gain resulting from the sale. Like the recapture provision in the Bush Administration’s description of the Single Family Homeownership Tax Credit, this provision appears to be intended to control gains by upwardly mobile homebuyers in gentrifying neighborhoods. The provision is modeled on the recapture provision in the Mortgage Revenue Bond program (S.143 of the Tax Code), which requires a written statement from the lender to the mortgagor at time of settlement but appears not to give the lender ongoing responsibility for monitoring recapture.

⁴⁰ *State of the Nation’s Housing 2001*.

⁴¹ US Department of Housing and Urban Development, *National Analysis of Housing Affordability, Adequacy, and Availability*. Using 1990 census data, this study shows that the biggest homeowner affordability gaps for low and very-low income renters are in northeastern cities and western cities and suburbs.

credit already exists. To encourage homeownership in the District of Columbia, the 1997 Taxpayer Relief Act provided a tax credit of up to \$5000 for taxpayers with incomes up to \$90,000 who buy a home in Washington DC and did not own a home there during the prior one-year period.⁴² The program proposed by English could cost as much as \$16 billion a year, based on current levels of first-time home purchases.⁴³

In a report to the Ford Foundation, Green and Reschovsky recommend a \$500 tax credit available annually to all homeowners, regardless of income or first-time buyer status, to be chosen at the taxpayer's option as an alternative to the mortgage interest deduction.⁴⁴ The authors estimate that such a credit would cost \$10 billion a year and increase the overall homeownership rate by 1.5 percentage points. While new homeowners would be concentrated among households with low and moderate-incomes, a major purpose of this tax credit would be income redistribution rather than creating new homeowners. The credit would provide tax relief to millions of current homeowners who do not benefit from the mortgage interest deduction.

It is possible to design a first-time buyer tax credit that has costs that are more modest and a design that is more parallel in intent to the other tax credits assessed in this paper. For example, the credit might be available only to first-time buyers with incomes below 80 percent of area median income. The credit could also be capped and allocated by the states, through lending institutions or community-based organizations.

2.3.1 Strengths and Weaknesses of a First-Time Buyer Tax Credit

Barriers to Homeownership

A tax credit provided directly to homebuyers would address directly the income constraint that prevents many low-income renters from becoming homeowners. Lenders could revise underwriting standards to take account of the additional income provided by the tax credit.⁴⁵ However, tax credits are not useable by households with incomes so low that they have no tax liability. To solve this problem, the tax credit could be made refundable, so that filers with a credit that exceeded their tax liability were entitled to an IRS refund, as is the case for the Earned Income Tax Credit.

If the credit could be used for a downpayment, it could also address the wealth constraint. However, there is a timing issue. A refundable one-time credit for first-time buyers would make funds available for a downpayment, but often more than a year after the date of home purchase.

⁴² \$130,000 for joint filers. IRS form 8859.

⁴³ Robert Rozen and Michael Collins, Homeownership Issues Memorandum for Millennial Housing Commission, draft September 10, 2001.

⁴⁴ Richard K. Green and Andrew Reschovsky, eds., *Using Tax Policy to Increase Homeownership Among Low- and Moderate-Income Households*. Report to the Ford Foundation, November 2001.

⁴⁵ The feasibility of this approach is supported by interviews with lenders reported in Alex Schwartz and Elvin Wyly, "Lending Industry Practices, Tax Policy, and Affordable Homeownership Opportunities," in Green and Reschovsky, *Op.Cit*, p.349.

Fannie Mae has solved this problem for the DC tax credit by agreeing to buy from loan originators a “tax credit equity loan” that becomes due upon receipt of a tax refund.⁴⁶

The tax credit proposed in the report to the Ford Foundation would provide a smaller amount annually and, therefore, it would be more challenging to transform such a credit into a front-end amount available for a downpayment. One of the report’s authors, Kerry Vandell, explores various options for monetizing the credit by having the homeowner sell it, either to a lender or to an investor who receives an equity position in the housing unit.⁴⁷

Targeting to Households with Barriers

As is the case for all homeownership tax credits considered in this paper, tax credits provided directly to homebuyers would be used extensively by households without barriers to homeownership. This would be even more the case for a tax credit with no income limit or a tax credit with a national income limit high enough to reach households barriers to home buying in all parts of the country. While an income limit based on local area median incomes would be preferable, administering such an income limit directly through individual household tax returns would be new.⁴⁸ Lenders or other entities allocating the tax credit to households would have to be given responsibility for certifying that the homebuyer was within the income limit, or at least for providing information on localized income limits to the individual taxpayer. If the tax credit were not rationed and allocated, IRS instructions to taxpayers would have to include information on local median incomes adjusted for household size.⁴⁹

For other types of tax credit, we are suggesting that outreach by community-based non-profits and fair housing groups would help target a rationed program to those with the greatest barriers to homeownership. However, for cash assistance (a tax refund) made directly to households, a rationing scheme based on something other than categorical rules (income or household composition) combined with “first-come-first-served” might be considered arbitrary and subject to abuse.⁵⁰

⁴⁶ The report to the Ford Foundation cited above notes that the effectiveness of this provision is limited because the DC tax credit reduces tax liability but is not refundable for those who would otherwise have no tax liability. Kerry Vandell, “The Homeownership Tax Credit and Downpayment Constraints,” in Green and Reschovsky, *op. cit.*

⁴⁷ *Ibid.*

⁴⁸ The income limits for occupants of rental housing developed with the LIHTC are administered by housing managers and state allocating agencies. Individual taxpayers do not need to apply those limits to themselves when filling out their tax returns.

⁴⁹ The program could have a relatively low single, national income limit, but this would likely tilt the program to non-metropolitan and other areas where barriers to homebuying are the smallest.

⁵⁰ Housing vouchers, because of their consumer-based character, seem to be more vulnerable to the claim that their rationed nature is unfair than are project-based rental housing subsidies.

Neighborhood Effect

A consumer-based tax credit might be used to promote homeownership in certain geographic locations. This is the case with the credit against federal tax liability provided to homebuyers in the District of Columbia. One can imagine a tax credit available only to homebuyers in “underserved areas” as defined by HUD⁵¹ or only to low-income homebuyers in areas where they are unlikely to afford housing without the credit. As we have suggested when reviewing other tax credit approaches, defining target neighborhoods in a way that does not concentrate low-income households, does not add to increases in housing costs where they are occurring already, and does not provide a subsidy to those who would have bought in the geographic area in any case would be very difficult.

Efficiency

A major appeal of a tax credit provided directly to homebuyers is that it would have low transactions costs and administrative costs. These efficiencies would be reduced, however, if the tax credit were refundable, if an annual stream of tax credits were made available for downpayment through sale to investors, or if a limited amount of tax credit authority were allocated through state agencies and lending institutions.

The Earned Income Tax Credit (EITC) is structured so that most households receive the credit as a tax refund once a year. Experience with that program indicates that large numbers of eligible households fail to file or file incorrectly.⁵² Extensive outreach would be needed to educate prospective homebuyers on the availability and correct use of the credit.⁵³ This could make it more difficult to target a rationed credit to those households with the greatest barriers to becoming homeowners because other eligible households would learn about the credit and apply for it.

Vandell reviews the factors that would determine the pricing of a debt instrument or an equity investment that would turn a stream of tax credit payments into a lump sum used for downpayment. He concludes that an equity investment would be preferable. While an equity investment appears more novel than a debt instrument, he notes that competitive pricing of a tax-credit based equity investment has developed for the Low Income Housing Tax Credit.⁵⁴

If a rationed tax credit were allocated to households through lenders or community-based institutions *and* if a periodic tax credit were monetized, it would be more efficient for those

⁵¹ HUD defines such areas now as regulator of the housing finance government sponsored enterprises, Fannie Mae and Freddie Mac.

⁵² Robert Greenstein and Isaac Shapiro argue that EITC error rates have been overstated and note that EITC errors are *not* associated with the credit’s refundable nature. “New Research Findings on the Effects of the Earned Income Tax Credit,” Center on Budget and Policy Priorities, March 11, 1998.

⁵³ Since the early 1990s, the IRS has informed households that appear to be eligible for the EITC and fail to claim the credit that they might be eligible if they filed amended tax returns. Carolyn J. Hill, V. Josephy Hotz, Charles H. Mullin, and John Karl Scholz, *EITC Eligibility, Participation and Compliance Rates for AFDC Households: Evidence from the California Caseload*, Prepared for State of California, April 1999, p.23.

⁵⁴ *Op. Cit.*

institutions to use the tax credit directly rather than to allocate it to a household and then buy it back. There would then be little distinction between a rationed tax credit used for downpayment assistance and the second mortgage option under the Mortgage Subsidy Tax Credit.

2.3.2 Design Features of a First-Time Buyer Tax Credit

On balance, there are strong reasons not to attempt to ration and allocate a homeownership tax credit that is provided directly to households. In order to preserve the efficiencies of such a credit, its cost should be controlled, and household targeting improved, through restrictions on eligibility rather than through an allocation scheme. The credit should be available only to first-time buyers, only available to those with incomes below 80 percent of area median income, and perhaps only available to households with children or other taxpayers filing as heads of household. Further analysis is needed to determine whether a still lower income limit—60 or 70 percent of median—would be too restrictive, in the sense of making the credit available only to households with barriers to homebuying so great that they would be unable to use it.

In order to be useable for downpayments with as little inefficiency as possible, a larger credit should be provided in the year the home is purchased, rather than a smaller credit available over several years. The credit should be fully refundable and its availability made known based on lessons learned from the Earned Income Tax Credit.

2.4 Flexible Tax Credit

The Flexible Tax Credit under consideration by the Millennial Housing Commission would be a capped allocation of tax credit authority to the states. States could choose to use their credit allocation for a developer-based Single Family Homeownership Tax Credit with a design similar to that proposed by the Bush Administration, for a lender-based Mortgage Subsidy Tax Credit with a design similar to that proposed in this paper,⁵⁵ or for both. The credit would be allocated on a per capita basis. It would be taken in the year the housing unit was sold to an eligible buyer or the subsidized mortgage product was originated. For both types of credit, eligible homebuyers would be first-time homebuyers with incomes below 80 percent of median, fully adjusted for household size.

Loans with a tax-credit based mortgage subsidy would not be assumable, but there would be no recapture provisions in the event of a sale. If homebuyers benefiting from the developer-based tax credit sold the housing unit within five years, recapture provisions would apply if the new buyer did not fit within the program's eligibility rules.

2.4.1 Strengths and Weaknesses of a Flexible Tax Credit

Barriers to Homeownership

The logic behind a flexible tax credit is that it provides the states with a flexible tool that can be used to overcome those barriers to homeownership that are associated with particular housing

⁵⁵ It is not clear whether deep mortgage insurance would be an eligible use of the credit.

markets. Additional units with prices affordable to low income households could be built in areas in which such units are in short supply, while in other areas the state could elect to use a mortgage subsidy tax credit.

We do not find this logic persuasive, because we believe that the Single Family Homeownership Tax Credit is an inferior mechanism for overcoming barriers to homeownership. While there are many areas, particularly portions of metropolitan areas, in which homeownership units are not affordable for low-income households, a subsidy that increases income (such as the First-time Buyer Tax Credit) or reduces the cost of borrowing (such as the Mortgage Subsidy Tax Credit) is, dollar for dollar, a more effective way of overcoming the income barrier to homeownership than building new units. Furthermore, the supply-side component of the Flexible Tax Credit would produce units sold at an appraised market value that is affordable for low-income households. By definition, that means that other units in modest neighborhoods already are affordable.

Furthermore, we do not believe it would be much easier for states than for the federal government to focus the use of a supply-side tax credit only on those narrowly defined geographic areas in which there is a supply constraint. For administrative convenience, many states would choose to implement only one of the two tax credits and would use it on a statewide basis. Any state that chose only the developer-based tax credit (and some surely would) would lose the greater ability of the Mortgage Subsidy Tax Credit to overcome income, wealth, and credit barriers to homeownership. A state that attempted to use both credits would be under great pressure to make the developer-based credit available in all areas that met the statutory requirements for geographic eligibility.

Targeting to Households with Barriers

Unlike the Bush Administration's proposal for a Single Family Homeownership Tax Credit, the developer-based component of the Flexible Tax Credit would produce housing available only to first-time buyers, and the income limit would be fully adjusted for household size. These are improvements. Nonetheless, this component of the Flexible Tax Credit is likely to be used by households that would have become homeowners without the subsidy because it will produce housing with the same sales price as other homeownership units in the same neighborhood.

To the extent that a state chose to use the Mortgage Subsidy Tax Credit rather than the Single Family Homeownership Tax Credit, it would be more likely to reach households with considerable income and wealth constraints. Devolution to the states of decision-making on the use of federal housing subsidy resources (both tax credits and direct appropriations) has been an increasing trend over the past twenty years and has permitted states to tailor the use of resources to local needs. It may not, however, make sense to give states the flexibility to choose an inferior approach to subsidizing low income homeownership.

Neighborhood Effect

A fundamental impetus behind turning federal subsidies for the production of low-income housing into block grants, from the Community Development Block Grant program through HOME, has been the greater ability of state and local decision-makers to use those resources as

part of multi-dimensional local plans for neighborhood improvement. Local decision makers choose locations and size types of housing investment to support those plans. In contrast, the components of the Flexible Tax Credit, put together, do not constitute a block grant. They are federal tax credits available through state allocation to private entities that would be constrained by explicit rules that must be followed to avoid recapture of the credit. Tax credits must be designed in this way, because otherwise it would be too difficult for the federal government to monitor them through the tax code. But that means that neither type of tax credit is sufficiently flexible to be tailored to the specific needs and strategies of a neighborhood.

The developer-based component of the Flexible Tax Credit would be limited to low-income neighborhoods—presumably, like to Bush Administration proposal, to census tracts with median incomes no greater than 80 percent of metropolitan wide area median income. The dangers of unintended negative effects that we have noted already would be present for those states that chose to use this component of a Flexible Tax Credit.

Efficiency

The relative efficiency of a tax credit depends on the evolution of standard investment products and a well developed, competitive market based on good information about the risks associated with those products. There is a good chance that such a system for pricing tax credits would evolve for a new tax credit, particularly for the Mortgage Subsidy Tax Credit, for which risks are likely to be more transparent than for a developer-based tax credit.⁵⁶ However, the larger the number of new tax-credit-based investment products introduced at the same time, the lower the chance that a relatively efficient market will emerge.

Transaction costs would also be higher for a Flexible Tax Credit than for either the Single Family Tax Credit or the Mortgage Subsidy Tax Credit taken alone. Those delivering the program and advising tax credit investors would be required to learn a wide array of program designs and compliance rules.⁵⁷

2.4.2 Design Features That Would Improve a Flexible Tax Credit

The Flexible Tax Credit does not have a program design separate from the Single Family Homeownership Tax Credit and the Mortgage Subsidy Tax Credit. The new feature is an attempt to put them together into a single allocation of tax credit authority to the states, in order to achieve some of the advantages associated with devolution of decision-making on the use of federal resources to the state level. Attractive though tax credits may be for their greater insulation from annual budgetary pressures and for the enlistment of private tax credit investors in

⁵⁶ One efficiency improvement in the Flexible Tax Credit is that the developer-based tax credit embedded in that proposal would have a shorter term than the original Bush Administration proposal and, therefore, would be less subject to the risk that the investor's tax situation or alternative investment opportunities might change in future years.

⁵⁷ It has been argued that one of the strengths of the LIHTC is that it is in fact a single, national program, although allocated by the states. This enables the effective participation of program users and tax credit investors in compliance with the program's rules.

monitoring compliance with program rules, block grants funded through direct appropriations are inherently more flexible and easier to mould to local needs and strategies.

Should legislative proposals for a Flexible Tax Credit go forward, however, many of the design improvements that we have suggested for the Single Family Homeownership Tax Credit and the Mortgage Subsidy Tax Credit should be considered. These include a set-aside for community based non-profits or fair housing organizations, well crafted requirements for homeownership counseling, and a formula that allocates tax credit authority to the states based on a measure of the relative lags in the homeownership rate among states.