

Increasing Homeownership Through Federal Tax Credits: A Discussion of Recent Proposals

Two new proposals could help low-income families build wealth and strong neighborhoods for less than two percent of current homeowner tax deductions.

By Eric Stein

A number of new federal homeownership tax credit proposals have recently been introduced. The goal of these suggestions is the same: to increase homeownership opportunities for low-income and minority families. While more Americans own their homes today than any time in U.S. history, homeownership among lower-income and minority families still lags significantly behind the population at large. Low-income and minority homeownership rates are 45 percent, while high-income and white family rates are at 86 percent and 72 percent, respectively.

Homeownership rates for different groups matter because homeownership is the primary path to the middle class for many families. Homeownership has been shown to reduce crime and teen pregnancies, while increasing school retention and graduation, civic engagement, children's future earning potential and overall life satisfaction. It also represents the best possible opportunity for wealth building and economic security by disadvantaged groups. This need is particularly acute for minority families—the wealth disparity between African American and white families is 10 to 1. Home equity represents two-thirds of all low-income



Eric Stein, Director of Secondary Market Programs at the Center for Community Self-Help

and minority family wealth. The median wealth of nonelderly low-income homeowners is 12 times greater than the median wealth of similar renters with the same income.

Tax credit proponents recognize that higher appropriations for programs that could increase homeownership, such as HOME or Community Development Block Grants, is unlikely in today's political climate. In addition, they realize that well-constructed tax incentives—such as the rental Low Income Housing Tax Credit (LIHTC)—can provide a decentralized, market-driven solution to housing problems. As applied to homeownership, however, the main tax incentive is the mortgage interest and property tax deductions, which cost the federal government \$58 billion each year. This program does not incent more low-income homeownership since 90 percent of

the benefits go to households earning over \$40,000.

For these reasons, proponents have suggested a new federal tax credit to promote homeownership. I am aware of four major proposals: two conceptual articles and two congressional bills. Michael Collins, Eric Belsky and Nicolas Retsinas of Harvard's Joint Center for Housing Studies wrote the first proposal, which was published by The Brookings Institution ("Brookings proposal").¹ Center for Community Self-Help Chief

Executive Officer Martin Eakes and I wrote the second article, which was published by the Progressive Policy Institute ("Self-Help proposal").² The first bill, S.1336, was introduced by Senator Jack Reed (D-RI),³ while the second is to be introduced in the second session of this Congress by Representative Lucille Roybal-Allard (D-CA).⁴ In this article, I will compare the two proposals and show how their ideas have been adopted in the Senate and House bills.

Comparison of Brookings and Self-Help Proposals: Similarities

The Brookings and Self-Help authors developed their proposals in collaboration with each other, so it is not surprising that they are roughly 80 percent the same. The first similarity is

¹"Towards a Targeted Homeownership Tax Credit," Brookings Institution's Center on Urban and Metropolitan Policy, January 1999. See www.brook.edu/ES/Urban/nic.pdf.

²"Achieving the American Dream: Increasing Homeownership Through a No-Interest Mortgage Tax Credit," March 1999. See www.dlcppi.org/texts/social/homeownership.htm.

³"Low-Income Second Mortgage Tax Credit." See http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=106_cong_bills&docid=f:s1336is.txt.pdf.

⁴"Homeownership Tax Credit Act of 1999."

that both would provide second mortgages to low-income families, according to HUD standards, those at or below 80 percent of area median income.

Self-Help came to this idea through its experience of helping to revitalize the Durham, NC, Walltown neighborhood near Duke University's East Campus. The neighborhood had become poor, blighted and dominated by absentee landlords. Self-Help has purchased 60 deteriorated rental or vacant houses on the worst blocks and has been restoring them to virtually new condition. After rehabilitation, the houses sell for about \$75,000. Hardworking but low-income local residents desiring to buy these houses, however, can only afford mortgages of roughly \$45,000. To fill this \$30,000 gap, Self-Help has packaged together subordinate mortgages that charge no- or low-interest from the City of Durham, the North Carolina Housing Finance Agency and the Federal Home Loan Bank of Atlanta. As a result, these families have been able to buy high-quality houses in their neighborhood, build wealth and are now contributing to the dramatic revitalization of a once-blighted area.

What we have found is that these no- or low-interest second mortgages address the twin wealth and income constraints that keep low-income renters from making the jump to homeownership. According to a recent U.S. Census study, only 1 in 10 renting families can presently afford to buy a modest home.⁵ One-third of these renters cannot buy because they lack the wealth to afford the downpayment and closing costs, even though they have the income to make the mortgage payments. The other two-thirds are constrained both by this wealth problem and a lack of income adequate to cover the mortgage payment every month.

These second mortgages open up the private marketplace dramatically. A family receives two mortgages: a market-rate first mortgage from a conventional lender and a second smaller mortgage. The size of the first mortgage is reduced

by the second mortgage. A lower first loan amount can solve the borrower's affordability problem by reducing monthly loan payments and downpayment requirements.

The second similarity is that the Brookings and Self-Help proposals both provide the same answer to the question of how to make second mortgages such as the ones Self-Help used in Walltown more broadly available throughout the United States. One could increase HOME funding dedicated to second mortgages or convince more states and municipalities to issue bonds like the City of Durham did. While there is some potential in these ideas, the payoff is probably limited. Nonprofits could make such loans. Besides the lack of funding for the mortgages, nonprofits such as Self-Help simply have limited reach (we have six branches in North Carolina and seven loan officers to serve a state of six million people).

The best entity to reach the thousands of families that need second mortgages to realize their homeownership dreams are conventional lenders, particularly commercial banks. Such lenders have thousands of branches and loan officers throughout the country, are very familiar with home lending and have identified borrowers who would need a second mortgage to afford a modest home. The challenge is to figure out how to compensate banks for providing these seconds since the borrowers cannot afford to pay interest on the loans. Brookings and Self-Help came to the same solution: The federal government should pay the bulk of the interest. Such payment could be in the form of a grant from the government; both proposals opt for instead the more palatable option of a tax credit on other income.

The third similarity is that both proposals chose the same method to allocate the credits to lenders. The choice is to use the successful LIHTC model of having state housing finance authorities distribute the credits through an auction so a market price determines

the amount of loans provided. Banks would take the credits over a 10-year period, to ensure good performance over time. Both would allow the credits to be sold on a secondary market.

Fourth, both proposals agree on the size of the program: \$1 billion per year, with an estimated impact of 50,000 renters turning into homeowners each year. During 10 years of issuing credits, 500,000 families would make the leap to homeownership. This funding would leverage, we estimate, \$23 billion of private mortgage financing.

Brookings and Self-Help Differences

However, the Brookings and Self-Help proposals differ on 20 percent of the details. The first difference is the form of the second mortgage. Brookings chooses a 30-year, 3 percent amortizing loan as its illustration. Self-Help, on the other hand, uses a 30-year, zero-interest balloon mortgage. The borrower makes no payments. The full amount of the loan becomes due at the earlier of 30 years,⁶ sale of the home or cash-out refinance of the first mortgage to ensure that equity remains in the house to pay off the balloon. This structure is more affordable than an amortizing loan because it does not charge the borrower interest, investors probably do not value small interest payments much and the balloon should not be a burden to refinance 30 years later since, with inflation, it should be worth less than 20 percent of its original value. The advantages of the Brookings structure are that the amortizing loan does eliminate the need to refinance at year 30 and adds some yield to the investor beyond the tax credit.

The second difference is servicing. The Brookings proposal requires servicers to collect principal and interest payments on the small loans for 0.38 percent per year in nonrevitalization areas. Self-Help's, by virtue of being a no-interest balloon, does not require servicing at all. In our experience, lenders will charge much more to service such small loans; the

⁵"Who Could Afford to Buy a House in 1995?" By Howard Savage, US Census Bureau. See www.census.gov/hhes/www/hsgaffrd.html. A modestly priced home costs less than 75 percent of owner-occupied homes in a particular region.

⁶Our Progressive Policy Institute paper uses a 25-year balloon; I now think that 30 years is preferable.

