

## Encouraging Homeownership Through the Tax Code

By William G. Gale, Jonathan Gruber, and Seth Stephens-Davidowitz

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### I. Introduction

Owning one's home is widely viewed as an integral part of the American dream. Americans are taught from an early age to aspire to homeownership, and several long-standing federal institutions and regulations support owner-occupied residential housing.

The income tax deduction for mortgage interest payments is possibly the best-known federal housing policy and is deeply ingrained in the economic and social fabric of the country. Evidence suggests, however, that the mortgage interest deduction (MID) does little if anything to encourage homeownership. Instead, it serves mainly to raise the price of housing and land and to encourage people who do buy homes to borrow more and to buy larger homes than they otherwise would. Most tax return filers, especially those with low or moderate incomes, do not itemize their deductions and therefore are not in a position to take advantage of the deduction if they were to buy a home. As a result, the deduction not only drains significant revenues from the Treasury every year, it also provides much larger benefits to high-income households than to low- or moderate-income households, and has at best a small effect on homeownership.

In light of those concerns, the President's Advisory Panel on Federal Tax Reform (2005) suggested major changes to the once politically sacrosanct MID. The panel proposed changing the deduction to a 15 percent credit and making it available to all filers, regardless of itemization status. Those proposals would partially address some of the problems noted above.

While we believe the panel's proposals regarding the MID would be a step in the right direction, we advocate bolder changes in federal housing policy. We propose a tax credit and a subsidized saving vehicle for first-time home buyers, financed by the elimination of the MID. Relative to current policy or to the panel's recommendations, our proposals would be less expensive, more progressive, and more effective in encouraging homeownership.

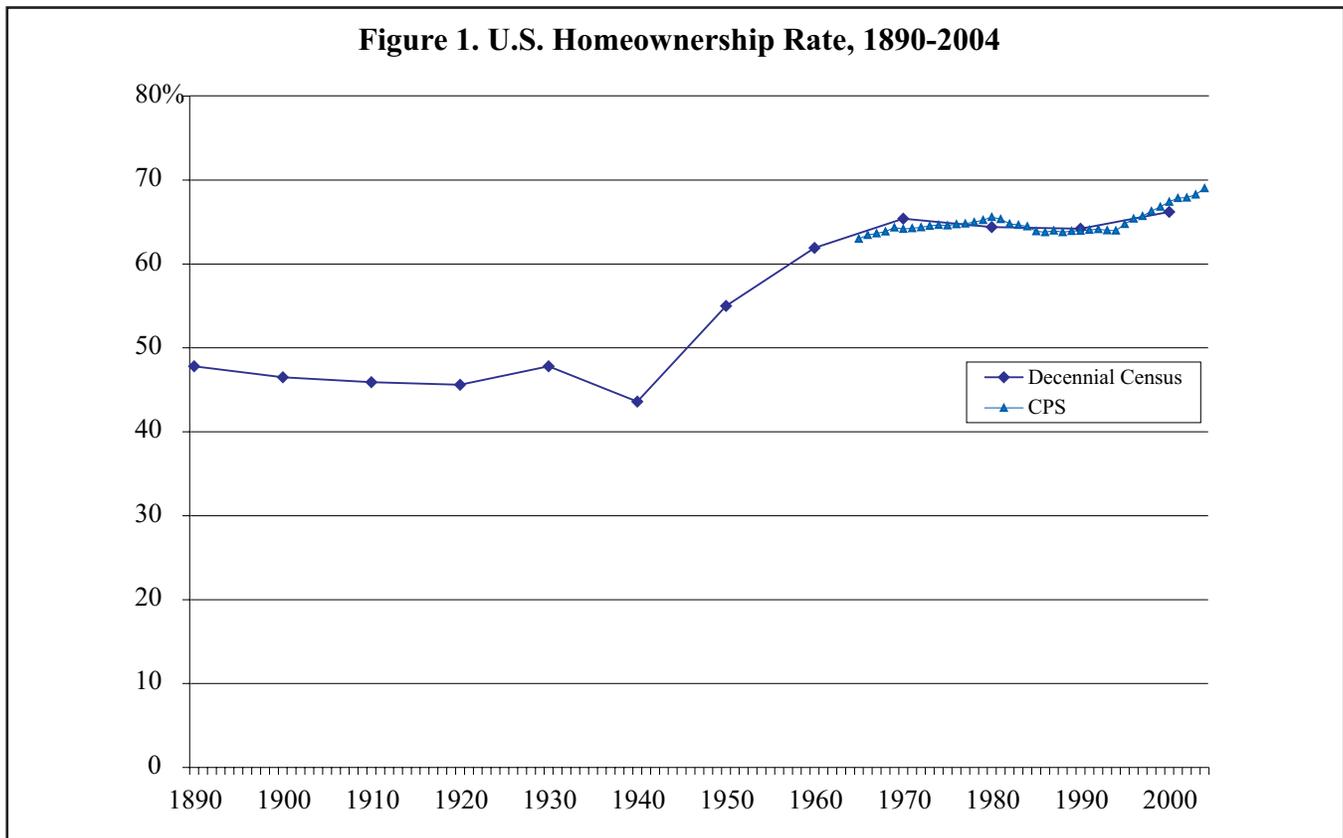
The report is organized as follows. Parts II and III provide background information on U.S. homeownership rates and federal housing policies, respectively. Part IV discusses the underlying justification for encouraging homeownership through public policy. Part V discusses the economic effects of the MID. Parts VI and VII describe our two proposed alternative policies and describe their potential effects. Part VIII is a short conclusion.

### II. Homeownership Trends and Patterns

In 1890 about 48 percent of American households owned their own homes (Figure 1, next page).<sup>1</sup> The homeownership rate was relatively constant from 1890 through 1930, fell somewhat during the Depression, and then began a sustained increase around 1940. Over the next 30 years, the homeownership rate rose dramatically, from less than 44 percent in 1940 to more than 65 percent in 1970. The increase was due to sustained prosperity after World War II and significant federal activity in the housing market, beginning in the 1930s. Federal policies included guaranteed low-interest mortgages to returning war veterans; an expanded interstate highway system in the 1950s, which allowed and encouraged widespread migration to the suburbs; and the creation and expansion of a variety of federal institutions designed to support homeownership.<sup>2</sup>

<sup>1</sup>Masnack (2001) provides a detailed analysis of the causes of changing homeownership rates over the last century.

<sup>2</sup>The federal institutions created included the following: the Federal Home Loan Bank System in 1932 to provide funds for lending institutions who offer mortgages; the Federal National Mortgage Association (Fannie Mae) in 1938, discussed later; the Federal Savings and Loan Insurance Corp. in 1934, which insured the deposits of federally chartered savings and loans institutions; and the Reconstruction Finance Corp. in 1932, which lent money directly to banks.



The rate of improvement of many economic measures slowed after 1970, including the homeownership rate. Between 1970 and 1990, the homeownership rate actually fell slightly. The rate rose during the 1990s and by 2005 had reached 69 percent, a record high, but an increase of less than 4 percentage points over the previous 35 years, after having increased almost 22 percentage points between 1940 and 1970.

Homeownership rates vary significantly across demographic groups. Figure 2 (next page) shows that whites have consistently had homeownership rates well in excess of the nonwhite population. The gap in ownership rates was 26 percentage points in 1900 and has remained stubbornly and troublingly high, at 22 percentage points in 2002.

Some of that variation arises from differences in the distribution of income across groups. Table 1 (p. 1174) shows homeownership rates in 2003 by income and race. Overall homeownership rates among blacks and Hispanics are slightly below 50 percent, compared with about 75 percent for non-Hispanic whites. Within each demographic group, homeownership rises dramatically with income. For example, for blacks, fewer than one-third of households with incomes below \$15,000 own their home, but more than 80 percent of those with incomes above \$100,000 do. Even after controlling for income, however, differences between whites and blacks in homeownership are substantial, between 16 and 34 percentage points for groups with incomes below \$50,000 and between 12 and 22 percentage points for groups with

incomes between \$50,000 and \$100,000. Studies suggest that, after controlling for a large number of observable characteristics, the unexplained black-white homeownership gap is smaller than just the differences by income class would suggest, but it still ranges between 5 and 10 percentage points (Charles and Hurst 2002; Gabriel and Rosenthal 2005; Herbert et al. 2005).

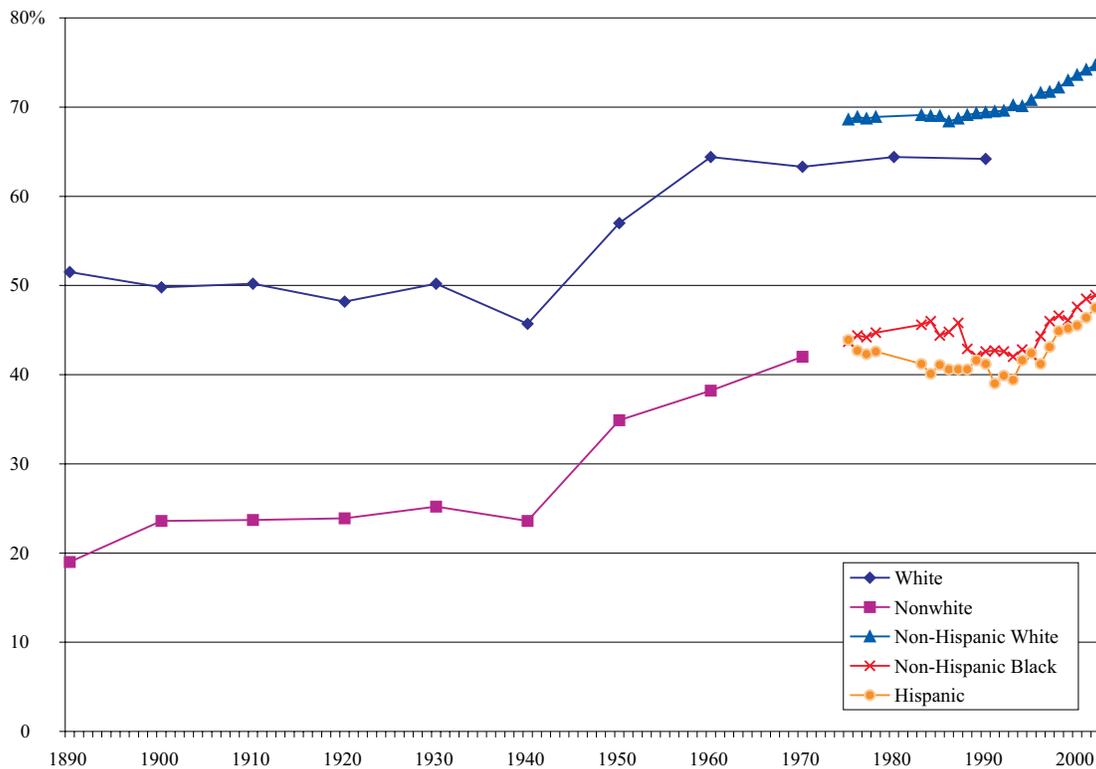
Table 2 (p. 1174) shows that homeownership rates rise dramatically with age in each demographic group and hover around 80 percent for households in age groups 50 and older. As a result, increasing homeownership rates to some extent involves accelerating the age at which people buy their first home, and to some extent involves converting long-term renters into homeowners.

### III. Federal Housing Policies

Although we focus on the MID, it is helpful to put that deduction in the broader context of federal policies regarding housing. We divide the policies into three broad categories: the income tax treatment of owner-occupied housing, subsidies for low-income housing, and institutions that focus on the operation of mortgage markets.

#### A. Income Tax Rules

The normal treatment of an asset under the income tax is to tax the net income the asset generates — that is, to subject the gross income to taxation but also to provide deductions for the expenses associated with earning the income. For residential housing, that treatment would tax

**Figure 2. U.S. Homeownership Rate, 1890-2002, by Demographic Group**

Source: Decennial Census and Current Population Survey

the gross imputed rent that the house generates — that is, the gross income the homeowner would receive if the house were rented out to someone else at market rates — and allow deductions for the costs of earning the gross income, including mortgage interest payments, depreciation, property taxes, and other expenses of maintaining or improving the property. Equivalently, the income tax would tax the net imputed rent (defined as the gross imputed rent less the deductions) and would tax it at the same rate as ordinary income. Also, any capital gains on the home would be taxed as ordinary income as the gains accrue.

The income tax treatment of housing, however, falls far short of that ideal. First, the income tax does not tax the gross imputed rent from owner-occupied housing. That differentiates the tax treatment of owner-occupied housing from that of rental housing; landlords are taxed on the gross income they receive from their tenants minus their expenses.<sup>3</sup> Second, despite not taxing gross

<sup>3</sup>Congress has periodically considered the taxation of net imputed rental income for homeowners. In 1986 the Joint Committee on Taxation reported, “While Congress recognized that the imputed rental value of owner-occupied housing may be a significant source of untaxed income, the Congress nevertheless determined that encouraging homeownership is an

(Footnote continued in next column.)

imputed rent on owner-occupied housing, the income tax does provide deductions for mortgage interest payments and property tax — that is, state and local real estate tax — payments for taxpayers who itemize their deductions. For mortgage loans of up to \$1 million, interest paid on mortgages for a primary or secondary residence may be deducted from taxable income.<sup>4</sup> In the most recent year for which individual, return-based data are available (2003), about 36 million taxpayers took the MID and about 38 million received the property tax deduction.

important policy goal.” Some developed countries, including Italy, Norway, and Denmark, do tax imputed rent, although it is suggested that the estimated rent is significantly lower than the market value (Sorensen 2001).

<sup>4</sup>The original federal income tax, instituted in 1913, allowed deductions for all interest paid, with no distinction made for business, personal, living, or family expenses. The option to take a standard deduction (and thus to forgo interest deductions) in lieu of itemized deductions was introduced in 1944. The Tax Reform Act of 1986 restricted the MID to loans for first or second homes and eliminated the personal interest deduction. The Omnibus Reconciliation Act of 1987 limited the MID to interest on the first \$1 million in principal on qualified loans. The Omnibus Reconciliation Act of 1990 further limited the value of the deduction by creating several limits on itemized deductions.

Income Range	All Households	Non-Hispanic White	Non-Hispanic Black	Hispanic
All	68.3%	75.4%	48.2%	46.3%
<\$5,000	48.9	61.9	27.5	28.3
\$5,000-\$9,999	39.4	48.8	32.8	22.2
\$10,000-\$14,999	46.7	60.2	33.0	28.7
\$15,000-\$19,999	47.0	63.1	37.5	26.2
\$20,000-\$24,999	49.5	65.0	37.4	32.9
\$25,000-\$29,999	43.5	68.0	43.5	41.5
\$30,000-\$34,999	54.2	69.2	43.8	36.8
\$35,000-\$39,999	55.9	69.2	50.4	48.8
\$40,000-\$49,999	61.2	73.5	57.4	48.6
\$50,000-\$59,999	69.5	78.9	57.2	59.7
\$60,000-\$69,999	75.1	82.1	70.6	66.2
\$70,000-\$79,999	79.0	85.1	73.2	71.3
\$80,000-\$99,999	85.0	89.0	76.5	74.7
\$100,000-\$119,999	88.7	92.6	80.7	78.4
>\$119,999	92.1	93.1	87.6	83.5

Source: Authors' calculations, using American Housing Survey, 2003.

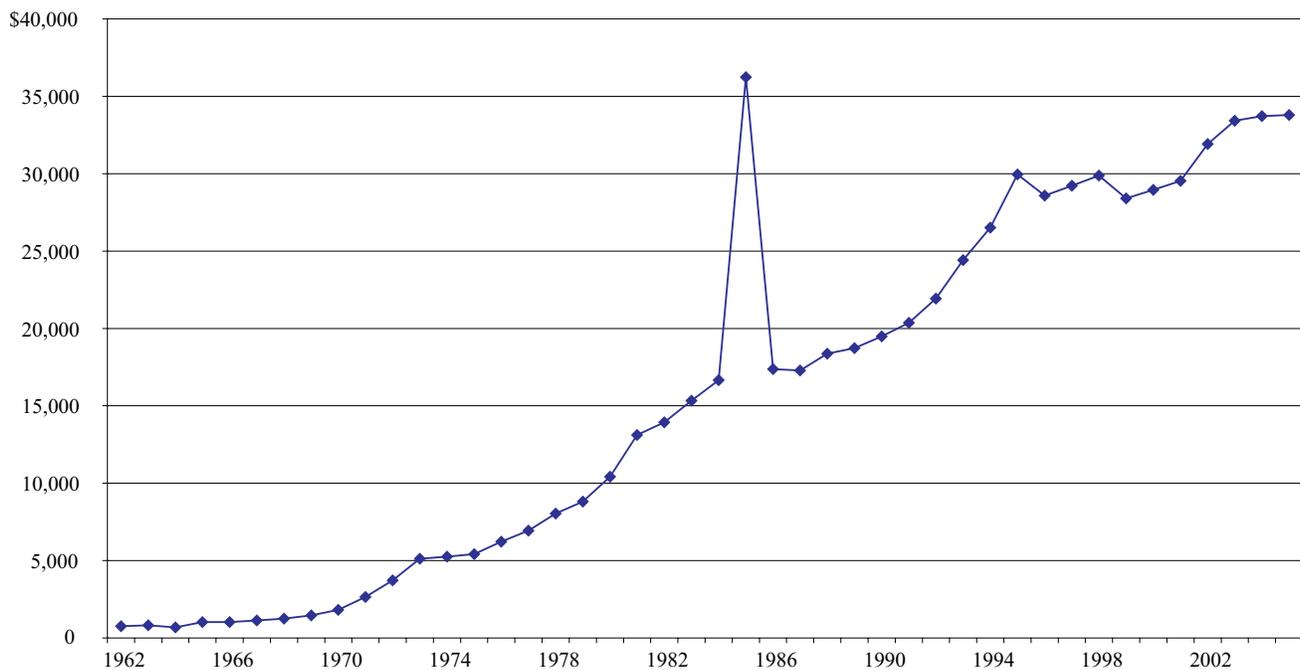
Age	All Households	Non-Hispanic White	Non-Hispanic Black	Hispanic
All	68.3%	75.4%	48.2%	46.3%
<25	21.5	25.5	12.2	15.4
25-29	39.2	49.1	23.1	28.9
30-34	54	65.5	33.5	38.8
35-39	63.1	74	40.3	47.7
40-44	69.3	78.6	50.2	51.8
45-49	74	81.7	53.1	53.8
50-54	77.5	83.8	60.1	62.5
55-59	78.9	84.7	64.7	63.1
60-64	81.1	86.7	64.5	64.7
65+	77.4	83.3	66.9	60.8

Source: Authors' calculations, using American Housing Survey, 2003.

In 2006 the overall federal tax expenditure due to the nontaxation of gross imputed rent exceeded \$115 billion. As noted above, gross imputed rent is equal to net imputed rent plus a variety of deductions. Thus, the tax expenditure for gross imputed rent can be allocated to a tax expenditure of \$29.7 billion for the nontaxation of *net* imputed rent, and tax expenditures of \$15 billion for the property tax deduction and \$72.1 billion for the MID (Office of Management and Budget 2006).<sup>5</sup>

<sup>5</sup>The gross imputed rental value of owner-occupied housing was about \$900 billion in 2004 in the National Income and Product Accounts (Bureau of Economic Analysis 2005, Table 7.12). Net imputed rental income for owner-occupied housing is calculated by subtracting mortgage interest payments, taxes, economic depreciation, and other costs. Mortgage interest payments will typically be less than gross imputed rent, but not necessarily less than net imputed rent.

Capital gains on owner-occupied housing are defined as the difference between the value of the house and the sum of the purchase price and the cost of any improvements. Like capital gains on other assets, the capital gains on an owner-occupied home are exempt from income taxation if the owner dies, are subject to tax only when the asset is sold, and are taxed at preferred rates (5 percent or 15 percent) relative to wage and other income (which are taxed at rates from 10 percent to 35 percent). Capital gains on owner-occupied housing also receive additional special tax benefits. First, capital gains on owner-occupied housing are taxable only to the extent the realized gain exceeds \$250,000 (\$500,000 for a married couple). To qualify for the exemption, the homeowner must have owned the property for two years and lived in it for two of the five years before the sale. Second, an owner who does not qualify can still get tax relief if the sale was due to an unforeseen circumstance, including death, divorce or legal separation, job loss, employment changes, or multiple births from the same pregnancy. The

**Figure 3. Real Low-Income Housing Assistance (Millions of 2000 Dollars), 1962-2004**

Note: The spike in 1985 is due to a one-time failure to roll over certain debt, not any functional, programmatic change.

Source: Office of Budget and Management

federal tax expenditure associated with exemptions from capital gains taxation on housing was \$39.8 billion in 2006 (OMB 2006).

### B. Direct Spending on Low-Income Housing

Although it is still significantly smaller than federal tax subsidies for homeownership, real federal spending for low-income housing rose substantially between 1970 and 2005 (Figure 3). That could well have played a role in stifling increases in homeownership during this period, because most such assistance goes to rental housing (Table 3) and thus may have the effect of discouraging home purchases.

Public housing is the oldest major rental program in the U.S. Established in 1937, public housing has been in decline in recent years; no new public housing units have been constructed since the early 1980s except those that were already planned. Many public housing units have been privatized. Nevertheless, 1.2 million individuals still live in public housing units. The Section 8 new construction and substantial rehabilitation program and the low-income housing tax credit pay private developers and owners of rental housing in exchange for charging lower rents. Vouchers (tenant-based rental assistance), most of which fall under the Section 8 program, directly subsidize tenants' rent. For example, under Section 8, eligible tenants are required to pay only a portion — usually about 30 percent of their incomes — of their rent. The federal government pays the remainder, subject

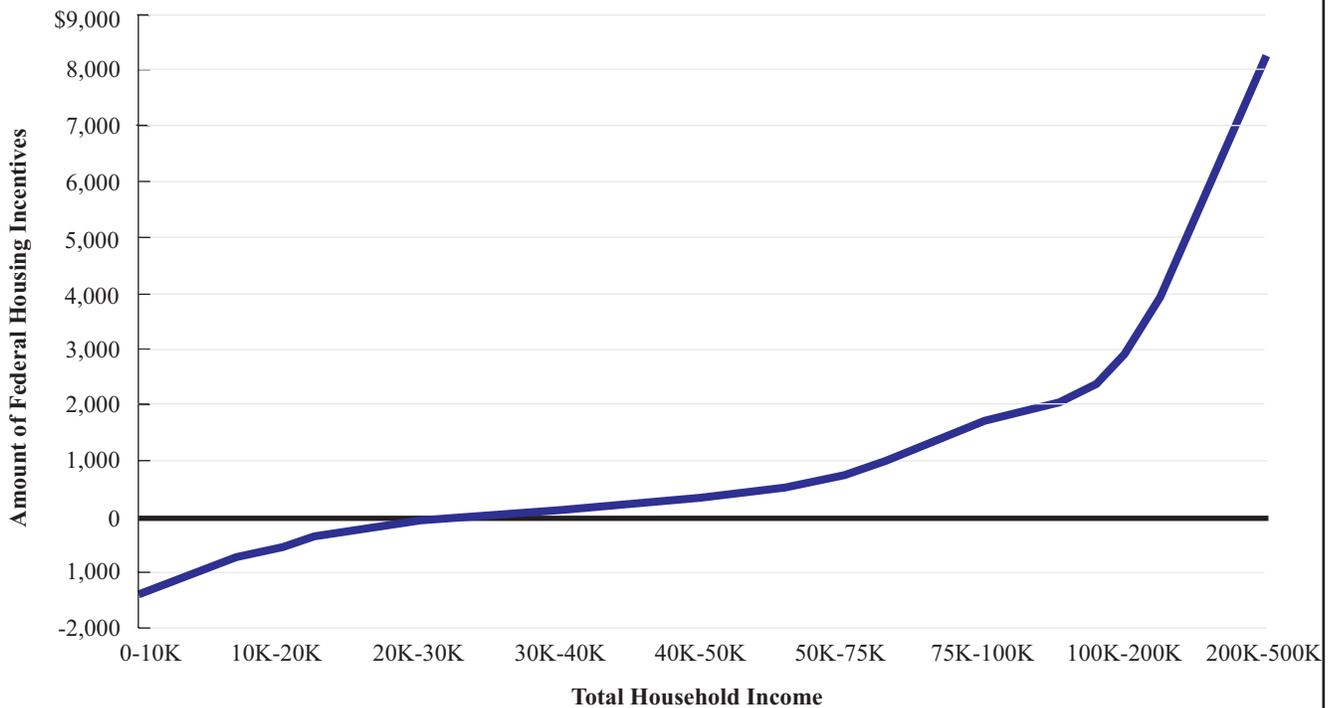
**Table 3. Federal Spending on Low-Income Housing**

	\$ Mil- lions
<b>Overall</b>	<b>\$33,042</b>
<b>Rental</b>	<b>27,783</b>
Public Housing	6,158
Project-Based Rental Assistance	8,770
Section 8 Contract Renewals	4,890
Credits for Low-Income Housing Investment	3,880
Tenant-Based Rental Assistance	12,855
<b>Ownership</b>	<b>2,218</b>
Mortgage Revenue Bonds	2,200
D.C. First-Time Homebuyers Credit	18
<b>Mixed</b>	<b>3,041</b>
Section 502 Single Family Housing Direct Loan	1,141
HOME Investment Partnership Program	1,900

Source: Housing and Urban Development fiscal 2005 Budget; Department of Agriculture fiscal 2005 Budget.

to a cap of the "fair market rent" determined by the Department of Housing and Urban Development. Currently, vouchers represent the most used federal low-income funding.

**Figure 4. S-Shaped Curve: Average Annual Federal Housing Incentives (Subsidies and Tax Deductions) by Total Household Income**



*Notes:* Includes households without subsidies and counts federal public or subsidized rental subsidies as *negative* housing incentives. The sample is restricted to individuals under 65 years old. Deductions include mortgage and property tax deductions. Not included are the exclusion of net imputed rental income, deductions such as the exception from passive loss rules for \$25,000 of rental loss, or accelerated depreciation on rental housing.

*Source:* The Urban Institute Transfer Income Model 2004 from Carasso, Steuerle, and Bell (2005).

A few small federal spending programs directly assist low-income homeowners. The federal government provides a nonrefundable federal income tax credit of up to \$5,000 to low- and middle-income families who purchase their first home in the District of Columbia. The federal government also pays for state housing agencies to issue tax-exempt bonds, as long as the proceeds (about \$9 billion per year) are used to issue below-market interest rate loans to first-time home buyers with low incomes. The state housing agencies can also convert issuing authority for those bonds into mortgage credit certificates (MCCs). Those credits provide a nonrefundable income tax credit of 10 percent to 50 percent of a borrower's annual interest payment.

Some spending programs provide support to both renters and owners. The Department of Agriculture's Section 502 single-family housing direct loan program offers discounted loans to low-income individuals living in rural areas to buy, build, repair, renovate, or relocate homes. The home investment partnership program provides state and local governments with block grants for housing assistance for low-income individuals, with most of the money not carrying restrictions on the nature of the assistance.

**C. Loan Guarantees and Secondary Markets**

Besides tax rules for housing and direct spending programs, the federal government plays an active role in mortgage markets. Four federal agencies insure mortgage loans for particular groups: the Federal Housing Administration (FHA) for low- and moderate-income families; the Department of Veteran Affairs for veterans; the Rural Housing Service for those purchasing farm property; and the Office of Public and Indian Housing for Native American tribe members. The Government National Mortgage Association, or Ginnie Mae, resells government-guaranteed mortgage securities to secondary market investors.

Private mortgages are often pooled and resold by government-sponsored enterprises (GSEs) such as the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corp. (Freddie Mac). Fannie Mae and Freddie Mac buy and hold mortgages that they finance by issuing debt in the capital market. Unlike Ginnie Mae, these GSEs are for-profit firms. The federal government provides Fannie Mae and Freddie Mac with a variety of explicit benefits, including a line of credit from Treasury, exemption from the Securities and Exchange Commission's registration and disclosure requirement, and exemption from state and local income taxes. The organizations also have some of their directors

appointed by the U.S. president. Those statutory provisions encourage a belief among investors that the organizations' liabilities actually are implicitly federally guaranteed. To the extent that belief pervades the market, the GSEs can borrow at lower rates of interest than private firms. The Congressional Budget Office (2004) estimates that in 2003 the implicit guarantee and related benefits from GSEs amounted to a federal subsidy in excess of \$23 billion, of which \$13.6 billion was passed through to borrowers as reduced rates in mortgage markets.

#### IV. Should Public Policies Encourage Homeownership?

That people want to own their own homes is not sufficient reason to subsidize home purchase. Subsidies can be justified to the extent that one person becoming an owner-occupier of a home brings spillover benefits to other members of society. That is, what is required is that there be societal benefits of homeownership beyond the individual benefits received by the home buyer.

Many positive spillover benefits of homeownership have been suggested. Most importantly, homeowners may be more likely to be active citizens working for long-term, communitywide benefits. Homeowners may also take better care of their houses than renters would. High rates of homeownership may reduce crime in the area, perhaps because the greater geographic stability of homeowners vs. renters means that someone committing a crime would be recognized. Any of these behaviors, if sufficiently prevalent, could plausibly raise property values in the community at large and hence provide a benefit to people other than the homeowner.

There is substantial evidence that is consistent with these claims. Controlling for other observable characteristics, such as income, marital status, and age, homeownership is positively correlated with having a higher propensity to belong to social groups and to maintain one's home, having more political knowledge, having higher political activity, and living in areas with lower crime rates (DiPasquale and Glaeser 1999; Galster 1983; Glaeser and Sacerdote 2000; Glaeser and Shapiro 2003; Rossi and Weber 1996). Areas with higher rates of homeownership also have higher prices of neighboring houses, controlling for neighborhood or household characteristics (Glaeser and Shapiro 2003; Coulson, Hwang, and Imai 2003).

Those correlations, however, do not prove that homeownership causes that behavior. Those who purchase homes may simply be the same individuals who are more likely to participate in those activities even absent homeownership; that is, it may not be homeownership per se that is causing more social group membership, but rather that those most likely to be members of social groups also end up owning homes. Likewise, lower crime rates in areas with high levels of homeownership may reflect uncontrolled differences that make those areas less crime-prone than areas with lower levels of homeownership. The results for the effects on housing prices may be difficult to interpret if a household's decision to own a home is correlated with other factors in the neighborhood, correlated with price, and not included in the controls. Finally, the effect of homeownership rates could be due in part to the fact that homeowners are more

**Table 4. Percent of Taxpayers Who Itemize, 2003, By Income Range**

AGI Range	Share Who Itemize
All	33.7%
<\$5,000	2.5
\$5,000-\$9,999	5.2
\$10,000-\$14,999	8.7
\$15,000-\$19,999	11.7
\$20,000-\$24,999	16.4
\$25,000-\$29,999	21.6
\$30,000-\$39,999	31.9
\$40,000-\$49,999	43.1
\$50,000-\$74,999	59.4
\$75,000-\$99,999	78.3
\$100,000-\$199,999	90.3
\$200,000-\$499,999	93.9
\$500,000-\$999,999	92.4
\$1,000,000-\$1,499,999	89.6
\$1,500,000-\$1,999,999	90.2
\$2,000,000-\$4,999,999	92.8
\$5,000,000-\$9,999,999	95.9
>\$9,999,999	97.2

*Source:* Authors' calculations, using data from the Statistics of Income Division of the IRS.

likely to support restrictive zoning measures that inflate prices (Glaeser and Shapiro 2003).

Thus, while there are some compelling arguments in theory for external benefits from homeownership, there is little evidence in practice to support those arguments. That does not prove that the arguments are wrong, but the burden should be on advocates of homeownership subsidies to make the case, and that case has not yet been made in a compelling fashion.

Even if there are no external benefits to owning a home, however, it may still be possible to justify subsidies to homeownership. The reason is that rental subsidies discourage homeownership, by encouraging people to rent their living space rather than to own it. As long as there are no negative externalities from owning as opposed to renting, then a subsidy for homeownership is needed, at least among the groups who receive rental subsidies, just to keep renting and owning on a level playing field.

Carasso, Steuerle, and Bell (2005) show that federal rental policies tend to subsidize low-income households. The net incentive created by federal policies to own vs. rent is S-shaped, as shown in Figure 4 on p. 1176, reproduced from their paper. The figure shows that at low-income levels, federal policies on net discourage homeownership. Hence, at least for households with incomes below \$30,000, a subsidy of some sort for homeownership could be justified as an attempt simply to place rental and owner-occupied housing on the same level. We note here, and discuss further below, that the MID provides little benefit for those households for the simple reason that few of them itemize their deductions. Table 5 (next page), for example, shows that households

in the lowest 60 percent of the income distribution obtain only 3 percent of the benefits; households in the lowest 80 percent of the distribution obtain less than 20 percent of the benefits.

Finally, a note of caution is warranted. It is possible that members of some groups, low-income groups in particular, are persuaded by others to purchase homes when they are not really prepared to take on the burdens and responsibilities of homeownership, or to take out unduly risky loans to finance a home purchase. To the extent that potential purchasers are making systematically poor decisions in favor of buying homes, it would be appropriate for policy to discourage those home purchases at the margin.

## V. An Economic Assessment of the MID

One of the popular misconceptions about the MID is that Congress created the MID to encourage homeownership. The MID was a feature of the original income tax, which took effect in 1913. The tax applied only to the top 1 percent of the population and was specifically designed to impose burdens on those who could afford most to pay taxes. It seems extremely unlikely that policymakers who were concerned that high-income households were not yet paying their fair share of public revenues would also be concerned about homeownership rates among the top 1 percent of the population.

### A. Revenue Effects

As noted above, the federal tax expenditure for mortgage interest deductions in 2006 was \$72.1 billion (OMB 2006). That is, the government estimates that if all taxpayers had the same mortgage interest payments but had been unable to deduct those payments from taxable income, federal revenues would have been higher by \$72 billion. That can be thought of as the “static” estimate of the revenue loss. Of course, in the absence of the MID, many home buyers would use less mortgage debt, which reduces the revenue loss from repealing the deduction. Taking those changes into account generates what might be called a “dynamic” estimate of the revenue changes.

We use the Tax Policy Center’s (TPC) microsimulation model to generate our own estimates of the static and dynamic revenue loss.<sup>6</sup> Static estimates from the TPC model indicate a revenue loss of about \$83 billion in 2006. To determine the dynamic revenue loss, we make two very strong assumptions, both of which reduce the revenue gain from repealing the MID. First, we assume that taxpayers reduce their taxable financial asset income by the minimum of either their total taxable financial asset income or their MID. For example, if a taxpayer has MIDs worth \$10,000 and has \$8,000 in taxable financial asset income (interest, dividends, capital gains), we assume that the taxpayer uses his existing assets to pay off enough mortgage debt to reduce his mortgage interest payments to \$2,000 and to reduce his taxable financial asset income to zero. If the same taxpayer had \$15,000 in taxable financial asset income, we assume that, under

<sup>6</sup>Information on the model available at <http://taxpolicycenter.org/taxmodel/>.

MID repeal, the taxpayer would have no mortgage debt and would have \$5,000 in taxable financial asset income.

Our second assumption is that taxpayers reduce their taxable financial assets in a particular order: assets that bear taxable interest first, assets that bear fully taxable dividends second, and assets that bear dividends that are taxed at a 15 percent rate or capital gains, which are also taxed at a 15 percent maximum rate, last.

Those two assumptions imply that taxpayers do a tremendous amount of tax avoidance in response to MID repeal. Even so, the revenue gain from repealing the MID under the assumptions is very high — about \$70 billion in 2006, or about 84 percent of the static revenue loss. Applying that adjustment to the OMB tax expenditure estimate suggests a dynamic revenue loss of \$60.5 billion in 2006.<sup>7</sup>

### B. Distributional Effects

In a static sense, the MID is an upside-down subsidy. Higher-income households are more likely to own homes (see Table 1), take itemized deductions (see Table 4), face higher tax rates, and own large homes. All of those factors raise the value of the MID for these households, relative to lower-income households.

Subtracting the amount of taxes paid from the amount of taxes that would have been paid with identical mortgages but no MID suggests that the deduction provides very large direct benefits to the highest-income households and very small benefits to households with incomes below \$50,000. The President’s Advisory Panel on Federal Tax Reform (2005) divided tax return filers into six income groups and showed the average value of the deduction in 2004 for each group. Those in the highest income group — individuals making more than \$200,000 per year — received more than eight times the benefit as those in the third income group — people making between \$50,000 and \$75,000 per year.

However, just as there is an important distinction between static and dynamic revenue effects, there can in principle be an equally important distinction between static and dynamic distributional effects. In particular, because high-income individuals tend to have more overall wealth, they would be the group most likely to be

<sup>7</sup>Follain and Dunskey (1997) calculate the dynamic revenue effect in a different way. They estimate an elasticity of mortgage debt with respect to its tax price of either -1.5 or -3.5, depending on the year. They allow households to respond to repeal of the MID by reducing their mortgage debt by the amount implied by these results, up to a limit of 25 percent of their “other assets,” where other assets include all financial assets, other real estate, and business assets. They find that the dynamic revenue gain from repealing the MID in 1989 would have been only 38 percent as large as the tax expenditure estimates in that year would suggest. That is, they have a much bigger dynamic response than we calculate in the TPC data. The principal reason for this, we believe, is that they base the taxpayer response on asset levels (taken from the Survey of Consumer Finances), whereas we look at taxable asset income on the tax forms. Their assumption would be appropriate if all income earned on financial assets, other real estate, and business assets were fully taxable at ordinary income tax rates in the period in which it accrued.

Table 5. Distributional Effects of MID Repeal, 2006

Cash Income Class	Static Case			Dynamic Case		
	Percent Change in After-Tax Income	Percent of Total Tax Change	Average Tax Change	Percent Change in After-Tax Income	Percent of Total Tax Change	Average Tax Change
All	-1.1%	100.0%	570	-1.0%	100.0%	480
Lowest Quintile	0.0	0.0	1	0.0	0.0	1
Second Quintile	-0.1	0.4	10	0.0	0.3	8
Middle Quintile	-0.2	2.6	73	-0.2	2.8	67
Fourth Quintile	-0.8	13.4	377	-0.7	14.5	343
Top Quintile	-1.6	83.7	2,236	-1.4	82.4	1,855

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).

Notes:

(1) Calendar year. Baseline is current law.

(2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>.

(3) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(4) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

able to respond to a restriction in the deductibility of mortgage interest by reducing their outstanding mortgages. That differential response from high-income households relative to middle-income households can affect the distributional estimates of who would be made worse off if the deduction were removed. Essentially, high-income households would be able to escape some of the increase in tax implied by restrictions in the MID, whereas low- or middle-income households would have less opportunity to do so.

Table 5 shows the results of static and dynamic distributional analyses of MID repeal using the TPC microsimulation model. The table shows that the distribution of the tax increases by income quintile is very similar under the two scenarios. That is, allowing people to use their financial assets to pay off or pay down their mortgage debt does not affect the distribution of the net increase in taxes very much. Results in Follain and Melamed (1998), shown in Figure 5 (next page), are similar. The distribution of benefits is somewhat less tilted toward high-income households in the dynamic estimates, but even in the dynamic estimates high-income households receive substantially larger benefits than low- or moderate-income households.

### C. Effects on Homeownership

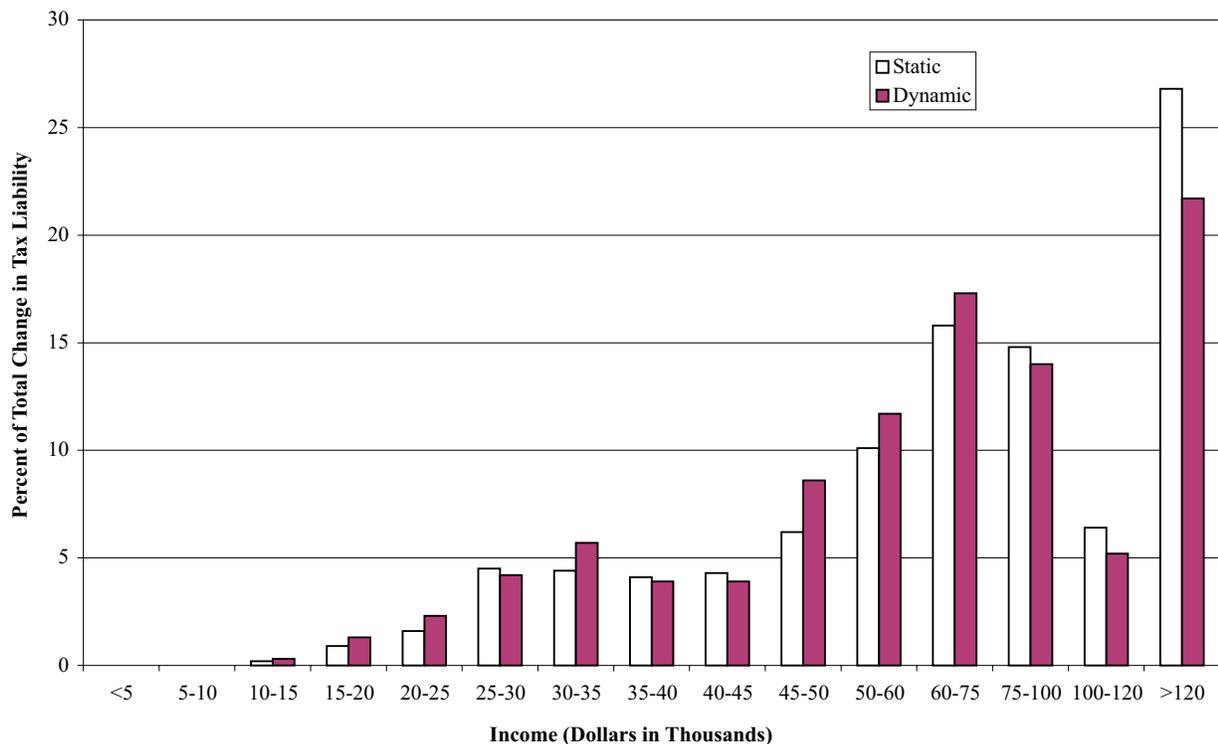
Both theoretical considerations and empirical evidence suggest that the MID has little if any positive effect on homeownership. Rather, the main effect of the MID appears to be to raise housing prices and increase loan-to-value ratios.

**1. Theory.** The effect of the MID on the rate of owner-occupied housing depends on both its effects on housing and its effects on homeownership rates. The effect of the deduction on the quantity and price of housing depends on the elasticity of the supply of housing. The more inelastic supply is, the more a subsidy to demand, like the MID, will show up as an increase in price. For

example, Capozza, Green, and Hendershott (1996) examine a model with fixed stock of housing (completely inelastic supply) and estimate that the MID increases the price of housing by about 10 percent. The increases are greatest in areas with high tax rates and house prices. Bruce and Holtz-Eakin (2001) estimate the effect of the MID in a model with infinitely elastic long-term supply of housing and thus find no long-term impact on prices. The elasticity of supply of housing is likely to vary across regions and within regions, since undeveloped land is scarcer in certain areas than others. On the two coasts, for example, the combination of high population density and land-use restrictions limit how much more housing can be built. In the interior of the country, those constraints are less binding (Green, Malpezzi, and Mayo 1999).

Given the stock of housing, the demand for homeownership depends on the relative price of owning vs. renting a home. Perhaps surprisingly, the MID can increase the demand for renting because of the following dynamic. The owners of rental housing are typically higher-income individuals, who face higher tax rates and thus benefit more from the MID than a typical renter, who has low income. Thus, by having a high-income owner rent to a low-income renter, a larger MID can be claimed than if the low-income person owned their own home, and the tax savings from the larger MID can be split in some fashion (depending on the supply and demand for rental units) between the renter and the owner.

Another way in which the MID can reduce demand for owner-occupied housing, given the stock of housing, stems from the fact that new homeowners typically are lower- or middle-income households who do not itemize. For those households, the MID provides no direct benefit. It may even provide indirect costs, since the availability of the MID generally will drive up the value of land and housing, as noted above. Thus, someone who is unable to take itemized deductions, even with an outstanding mortgage loan, or is able to take them but faces only a 10

**Figure 5. Static and Dynamic Estimates of the Allocation of Benefits of the MID, 1989**

Source: Follain and Melamed (1998).

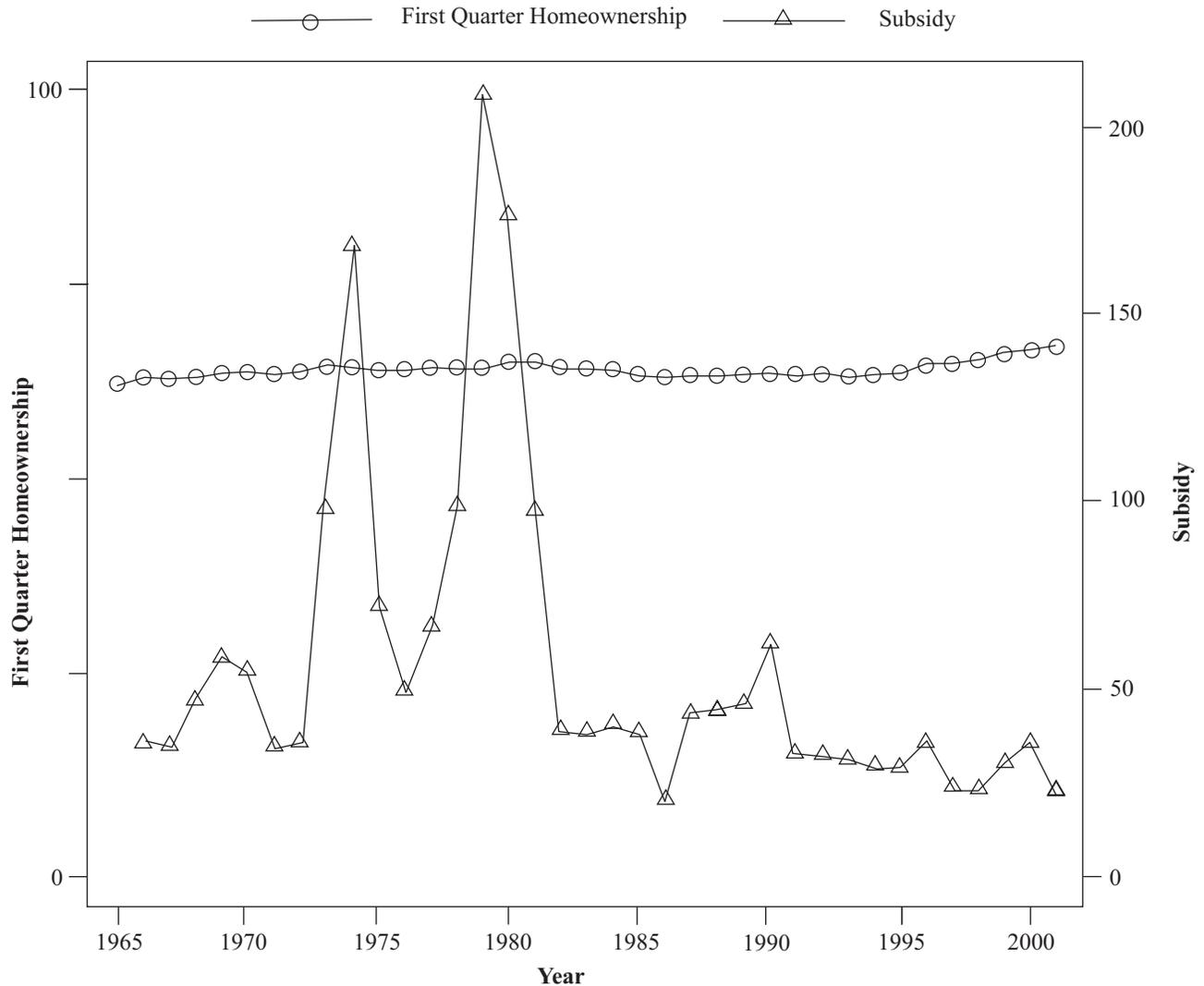
percent or 15 percent marginal tax rate, may find that the costs of the MID outweigh the benefits.<sup>8</sup>

**2. Evidence.** Time-series evidence in the U.S. provides little reason to believe that the MID has a substantial influence on homeownership. The value of the deduction increases with the inflation rate and independent increases in the value of itemization (such as increases in tax rates). Despite substantial variation in the values of inflation and itemization — and thus the MID — over the past 40 years, the homeownership rate has barely budged (see Figure 6, next page, taken from Glaeser and Shapiro 2003). More formal time-series models based on those data also find no effect of the MID on homeownership (Glaeser and Shapiro 2003).

<sup>8</sup>Building on the distinction between housing and homeownership, Glaeser and Shapiro (2003) note a limit to how much the MID — or any policy — could promote homeownership. They note that different types of structures differ in their likelihood of being occupied by owners or renters. About 85 percent of individuals living in single-family detached homes and 80 percent of people in mobile homes own, while 86 percent of those in multifamily units rent. That reduces the elasticity of homeownership by requiring a large decrease in the relative price of owning and renting to change some types of housing from rentals to ownerships.

Nor does cross-country evidence provide reason to believe the MID has an important impact on homeownership. Table 6 (p. 1182), taken from Mann (2000), lists homeownership rates and housing policies for several industrialized countries. While such cross-country comparisons are always difficult and the treatment of net imputed rental income seems to drive a good portion of the variation, there is no evidence of the large correlation between mortgage interest deductibility and homeownership one might expect if the MID had a big effect. Switzerland, which allows MIDs, has the lowest homeownership rate at 28 percent. Australia, which does not allow the deduction, has the highest rate at 70 percent. Canada, which does not allow the deduction, has a homeownership rate similar to that of the U.S.

A comparison of homeownership trends in the U.K. and the U.S. is consistent with the view that the MID has little impact on homeownership (Gale 1997, 2001). When tax subsidies for most forms of borrowing were eliminated in the U.K. in 1974-1975, subsidies for interest on the principal primary residence were retained, subject to a loan limit of £25,000. No subsidies were provided on second homes. The limit was raised to £30,000 in 1983-1984 and has stayed fixed since. Mortgage tax relief after 1974 was initially provided at the taxpayer's marginal income tax rate. More recently, the subsidy has been provided only up to a fixed rate, first set at 25 percent and then reduced to 15 percent for new loans in 1998. The

**Figure 6. Homeownership and Inflation, 1965-2000**

*Notes:* The subsidy series shows the effect of federal taxes on the price of owner-occupied housing, based on the 12-month consumer price index inflation rate before the first quarter of each year. Data from <http://www.freelunch.com>. See Section III for a discussion of the calculation of the subsidy. The homeownership rate is the estimated rate for the first quarter of each year. Data from <http://www.census.gov>.

*Source:* Glaeser and Shapiro (2002).

decline in the value of mortgage interest subsidies has been gradual but gigantic. Because of inflation, declining interest rates, and lower subsidy rates, the value of the MID fell by about 90 percent between 1974 to 1996.

It is very difficult, however, to find much effect from that change in the data. Between 1981 and 2004, the British homeownership rate rose 13 percentage points (Figure 7, next page). By comparison, U.S. homeownership rates rose by less than 4 percentage points over the same period. Of course, many factors affect the homeownership rate. Some of the increases in the U.K. were due to privatization of public housing in the 1980s.

Nonetheless, the double-digit increases in the homeownership rate during the same period as huge reductions in mortgage subsidies is striking evidence against a large effect from the MID.

#### **D. Income Tax Principles and the MID**

Even if it is acknowledged that the MID reduces federal revenues, provides large net gains to wealthier households, and has little positive — and potentially negative — effects on homeownership, there is still a line of argument that is often made in favor of retaining the deduction. That argument is that the real problem with

Country	Mortgage Interest Deduction?	Tax Imputed Rent?	Home Ownership Rate
Australia	NO	NO	70%
United Kingdom	YES, limited to 10%	NO	68
United States	YES, limited to \$1,000,000	NO	67
Canada	NO	NO	63
Japan	NO	NO	59
France	NO	NO	56
Sweden	YES	YES	56
Netherlands	YES	YES	45
Germany	NO	NO	42
Switzerland	YES	YES	28

Source: Mann (2000).

the tax treatment of owner-occupied housing is not the MID but that imputed rent is not taxed (see, for example, Follain and Melamed 1998).

That argument is premised on two claims. First, if gross imputed rent on owner-occupied housing were subject to taxation, the MID would be appropriate. We agree with that claim. Gross imputed rent on owner-occupied housing is not currently taxed, however, and there is virtually no chance that it will be taxed in the U.S. in the foreseeable future. As a result, a search for alternative, or second-best, tax policies toward housing is necessary.

The second claim is that the MID simply serves to equalize the cost of alternative ways to finance a house purchase. Specifically, people can finance a purchase by using funds that they would have invested in another asset or by borrowing funds. For tax policy not to distort that choice, the net cost of each financing option should be the same. For example, if people earn a pretax return of  $r$  on an alternative investment and pay a tax rate of  $t$  on that return, the after-tax return to the alternative investment is  $r(1-t)$ , as is the opportunity cost of using that investment to pay for a house. Thus, the argument goes, allowing the deduction of mortgage interest payments — which reduces the net interest cost of borrowing from  $rm$  to  $rm(1-t)$ , where  $rm$  is the gross mortgage interest rate and is assumed to be roughly equal to the gross return on other assets — has the virtue of equating the net cost of financing a house with debt and of financing a house with funds that would have gone to other investments.

While we agree with that view in principle, we do not believe that in practice it suggests that mortgage interest should be deductible. The reason is that potential homeowners have a variety of alternative investments, almost none of which imply that mortgage interest should be fully deductible. For example, the tax rate on taxable dividend income is at most 15 percent. Likewise, the statutory tax rate on taxable capital gains is at most 15 percent, and because of the deferral and other special features of capital gains tax rules, the effective tax rate is far lower. Finally, households can invest substantial amounts in tax-deferred accounts like 401(k) plans and individual retirement accounts, which imply effective tax rates of zero or even negative values.

Note that the  $t$  that applies to the taxation of income from other investments differs dramatically across investments and in many cases is far lower (and in some cases is zero or negative) than the tax rate at which mortgage interest payments are deducted under current law.<sup>9</sup> To remove the distortion between methods of financing a home purchase, it is appropriate to allow the deduction for mortgage interest payments only to the extent that households cannot invest in tax-deferred retirement accounts on the margin. Since, empirically, almost no household contributes the maximum for all of its eligible retirement accounts, the tax treatment that removes the distortion between methods of financing for almost all households is to set the mortgage interest deduction equal to zero.

A related concern is that, as long as tax-deferred accounts are available and mortgage interest payments are deductible, taxpayers will have incentives to create tax shelters by contributing to tax-deferred accounts and financing the contribution with mortgage debt. That creates significant tax savings for the households but does not generate any net new private saving. (See Engen and Gale (2000) for further discussion and evidence.)

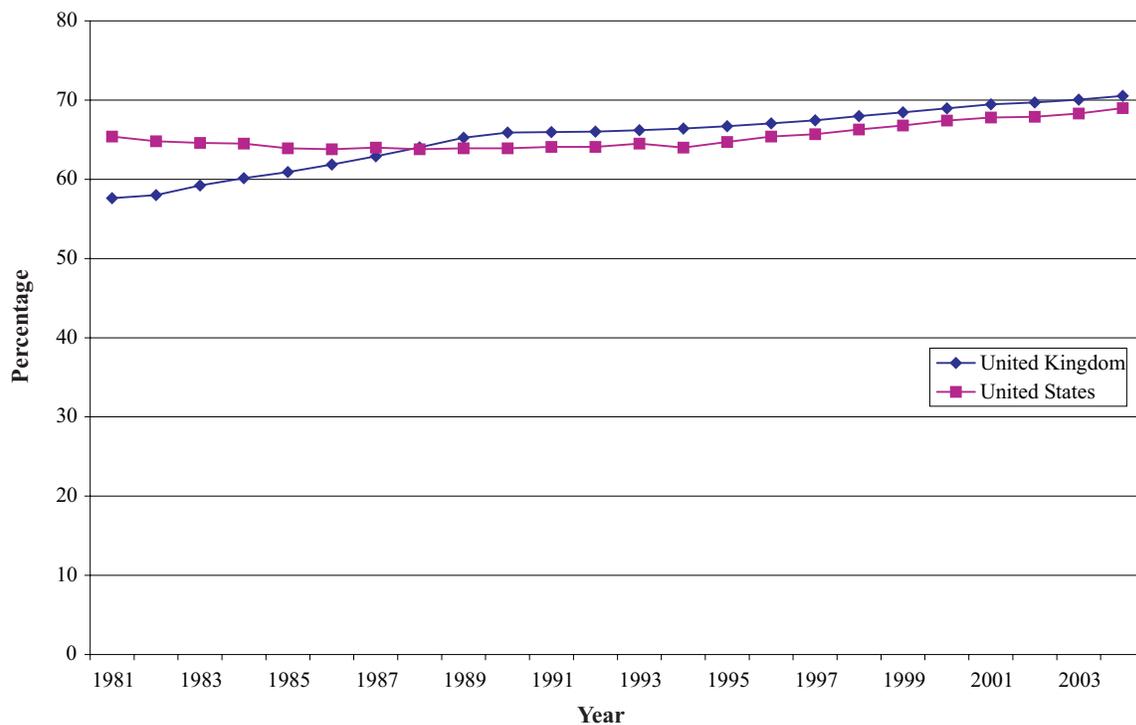
## VI. A First-Time Home Buyers Tax Credit

As we have shown, the MID is expensive and regressive, and it does little to encourage homeownership. In the next two sections, we discuss better ideas. We begin with a first-time home buyers credit (FHC) that is financed by full or partial repeal of the MID.

### A. Proposed Design

The FHC would be fully refundable and would be available only to households in which no members have owned a home in the previous three years. Both of those features are essential for the credit to accurately target new home buyers and low-income individuals. If it were

<sup>9</sup>The effective tax rate is negative in a traditional 401(k) or IRA when the tax rate that applies when the contribution is made and deducted from taxable income is larger than the tax rate that applies when the funds are withdrawn and counted as taxable income. See Burman, Gale, and Weiner (1998).

**Figure 7. U.K. and U.S. Homeownership Rates, 1981-2004**

Source: Current Population Survey and U.K. National Statistics.

not refundable, many low-income individuals could not receive the full — or in some cases, any — benefit. The three-year window for not owning a home is meant to be a compromise: A tax return filer would not have to prove nonhomeownership for an entire lifetime, but most people who buy and then sell a home may be expected to purchase a new home less than three years in the future.

The credit would be \$6,000 for married couples filing jointly, and \$3,000 for tax filers who are single, heads of households, or married individuals filing separately.<sup>10</sup> It would be available, in full, for married couples filing jointly with a combined income up to \$150,000, and

others with income up to \$75,000 and phased out at a 10 percent rate for households with higher income (and so would phase out completely at income levels of \$210,000 for married couples filing jointly and \$105,000 for others). The credit would be paid in the tax year following the year of purchase or would be spread out over two years. All numbers would be indexed for inflation.<sup>11</sup>

### B. Revenue Effects

The FHC would cost significantly less than the current MID. The cost of the credit is the product of the number of first-time home buyers times the cost per buyer. Rough estimates suggest somewhere between 3 million and 3.5 million first-time home buyers in 2006,<sup>12</sup> fewer than 60

<sup>10</sup>Alternatively, the credit could be set to vary with housing prices in a region. The Federal Housing Administration (FHA) insures loans of up to 95 percent of the median home price in the district in which the home was purchased, subject in 2006 to a minimum of \$200,160 for a single-family home and a maximum of \$362,790 (FHA 2006). Thus, setting the credit for married couples filing jointly at 2.5 percent of the limit of FHA-insured loans for single-family homes in the region and the credit for others at half that amount would cost roughly the same amount as our proposal. Whether the subsidy should be adjusted across regions is an open question. To the extent that higher housing prices reflect the amenities of living in an area, owners are already compensated for the higher prices they pay. To the extent that higher housing prices represent higher regional demand for the land or higher regional construction costs, the justification may differ.

<sup>11</sup>A similar plan sponsored by Sen. Debbie Stabenow, D-Mich., was introduced in 2003 and reintroduced in 2005 (Library of Congress 2003, 2005). Our proposal differs in at least two ways: We tie the enactment of the credit to repeal of the MID, and we do not link the benefit to the purchase price of the house. Linking the benefit to the purchase price gives an inappropriate incentive to purchase more expensive (for example, bigger) homes, for which there is little evidence of positive externalities and even some evidence of negative externalities (Glaeser and Shapiro 2003).

<sup>12</sup>The National Association of Realtors (NAR) estimated that there were 3.3 million first-time home buyers in 2005 and found that the number grew by almost 200,000 per year over the past five years. Their numbers tend to be higher than estimates from the American Housing Survey (AHS). In 2001, the last year for

(Footnote continued on next page.)

**Table 7. Distributional Effects of Replacing Mortgage Interest Deduction With Credit Equal to 1.03 Percent of Home Value up to \$100,000 for All Homeowners**

Cash Income Percentile	Percent of Tax Units		Average Federal Tax Change	
	With Tax Cut	With Tax Increase	Dollars	Percent
Lowest Quintile	26.2%	0	-\$225	-93.5%
Second Quintile	39.2	0.1	-349	-25.4
Middle Quintile	40.6	1.1	-328	-6.7
Fourth Quintile	43.2	2.8	-233	-2.1
Top Quintile	43.6	7.6	1135	2.5
All	48.5	16	0	0

Source: Carasso, Steuerle, and Bell (2005).

**Table 8. Income Distribution of First-Time Home Buyers, Other Homeowners, and Renters**

Family Income Range (Thousands \$)	First-Time Home Buyers	Other Homeowners	Renters
<\$5	2.7%	3.8%	9.4%
5-10	2	3.6	11.1
10-15	3.1	5.1	10.7
15-20	4.3	5	10.3
20-25	6.2	5.4	9.8
25-30	7.2	5.8	8.4
30-35	7.7	6.1	8.6
35-40	7.9	4.9	6
40-50	11.8	8.9	8.4
50-60	10.1	8.3	5.4
60-70	9.4	7.6	3.5
70-80	7.3	6.5	2.4
80-100	8.5	9.3	2.6
100-120	4.4	6.4	1.2
>120	7.4	13.3	2
Median	48,000	51,000	24,590

Source: Authors' calculations using the American Housing Survey (2003). First-time home buyers are defined as any household that purchased their first home between 2001 and 2003 and are still living in that home; other homeowners are all other homeowners; all incomes are from 2003.

percent of whom are married.<sup>13</sup> Even if the larger number of home buyers is used and it is assumed that all first-time home buyers are eligible (that is, no income restrictions),<sup>14</sup> and that 60 percent of first-time buyers are married couples filing jointly, the 2006 cost of the credit comes to only \$16.8 billion, substantially less than the revenue gain from repealing the MID.<sup>15</sup>

which data is available for both surveys, the NAR estimated there were 2.6 million first-time home buyers, while the corresponding number from the AHS was 2 million.

<sup>13</sup>Of households that purchased their first home between 2001 and 2003, 56 percent were married in 2003 (AHS 2003).

<sup>14</sup>AHS data suggest about 8 percent of first-time home buyers would be affected by the income limits and 3 percent would receive no benefit.

<sup>15</sup>The Joint Committee on Taxation (1992) estimated that then-President George H.W. Bush's 1992 proposal for an 11-month first-time home buyers tax credit would reduce revenues by \$6.1 billion, or about \$7.5 billion in 2006 dollars. Under that

(Footnote continued in next column.)

### C. Distributional Effects

The FHC would be more progressive than the MID. Repealing the MID and creating a revenue-neutral fixed credit for *all* homeowners would be progressive. The fixed credit would yield a constant benefit per homeowner. The benefit of the MID, in contrast, rises with the size of the MID, the marginal tax rate, and the propensity to itemize, all of which rise with income in the current system. Progressivity would be increased by adding the income cap. Table 7, taken from Carasso, Steuerle, and Bell (2005), shows the effect of replacing the mortgage interest deduction with a refundable credit for all homeowners equal to 1.03 percent of the purchase price of a home up to \$100,000. As can be seen, the bottom four quintiles all see their tax burden go down, whereas the

proposal, the credit had limited refundability and had a value of 10 percent of the purchase price up to \$5,000 with no income cutoff.

**Table 9. Change in Homeownership Rates From Replacing MID With Refundable Credit For All Homeowners**

	With Full Set of Controls	Without Controls for Household Type
All	2.7%	1.2%
<b>By Income Range (Thousands \$)</b>		
<\$10	13.5	6.2
10-20	7.6	3.3
20-30	3.3	1.5
30-40	0.8	0.5
40-50	-2.7	-1
50-60	-5.8	-2.2
60-70	-6	-2.3
70-80	-5.6	-2.1
<70,000	-4.4	-1.6
<b>By Race</b>		
Black	9.6	3.9
Non-White	7.8	3
White	-1.8	0.9

Source: Green and Vandell (1999).

top quintile faces a significant increase. We would expect our plan to be more progressive. First, a credit for first-time home buyers will be more progressive on current income than a credit for all homeowners because first-time purchasers tend to have lower income than owners on average. (Compare columns 1 and 2 in Table 8.) Second, our credit is a fixed amount, not a share of home price.

Even viewed over the course of a lifetime, the credit would be more progressive than the current MID. Abstracting from any effect on homeownership, the credit amount would be capped and much flatter for income than the MID. And to the extent that the credit raised homeownership rates (see below), it would provide benefits to households, presumably those with lower incomes, who otherwise would not have received homeownership subsidies at all.

#### D. Potential Effects on Homeownership

Replacing the MID with the FHC would increase homeownership. As discussed earlier, the MID, by giving benefits primarily to wealthy individuals not on the margin of the homeownership decision, is poorly designed to encourage homeownership. The FHC, by contrast, would target low-income first-time home buyers, the very individuals debating whether to purchase a home.

Evidence from simulations consistently supports the notion that converting the mortgage interest deduction to a flat credit for *all* homeowners would raise the homeownership rate (Rosen 1979a, 1979b; Reschovsky and Green 1998; Green and Vandell 1999). Green and Vandell, for example, find that replacement of the MID and property tax deduction with a revenue-neutral credit of \$1,173 for all homeowners would raise homeownership rates by 1-3 percentage points (see Table 9). Rates would

rise very substantially for households with income below \$30,000 and for blacks and other non-whites. Homeownership rates would fall for high-income households and whites.

Evidence from similar programs is spottier, but generally consistent with those findings. In 1983 Australia adopted the First Home Owners Scheme (FHOS), which provided first-time homeowners with almost \$6,000 in present value of benefits if their taxable income was less than 130 percent of the average male's weekly earnings and the household had more than one person who depended on the support. There was a limit to the price of housing for which the credit could be used. Borrowers could take the subsidy as an upfront lump sum, a cash flow subsidy declining over five years, or a combination. About 80 percent chose the first option. The program ended in 1991, but a grant under the same name, although lacking income cutoffs, was introduced in 2000. One study, which predicts the probability of owning one's home in Australia based on demographics, income, wealth, the comparative value of owning versus renting, and the value of the FHOS subsidy, finds that the FHOS subsidy raises homeownership. For household heads between the ages of 21 and 25, eliminating the subsidy causes the homeownership rate to decline from 37.1 percent to 28.5 percent, a 23 percent drop, with an even more pronounced effect among lower-income individuals (Bourassa et al. 1994).<sup>16</sup>

As discussed in Part III, the U.S. has two programs — the D.C. first-time home buyer tax credit and MCCs — funded at the federal level but administered at the state or local levels that give credits to first-time home buyers. There is suggestive, but not conclusive, evidence that those programs have spurred first-time homeownership. For example, the percentage of first-time home buyers among all home buyers after introduction of the D.C. first-time home buyer credit was far higher in D.C. than in comparable cities, suggesting that new buyers were entering the home market who would not have otherwise. Also, the program was successful at targeting low-income individuals: 39 percent of participants had incomes between \$30,000 and \$50,000, and 28 percent had incomes between \$50,000 and \$75,000 (Tong 2005). Among those participating in an MCC program in North Carolina in 1987, about 22 percent said they would not have purchased the house without an MCC (Stegman and Stebbins 1992).

The FHC would likely be more effective at encouraging homeownership than either the D.C. program or MCCs, both of which offer nonrefundable credits. The refundability of the credit would be crucial for the millions of eligible families who do not face positive federal income tax liability. In addition, our plan would differ from the MCCs in not tying the credit to mortgages. About 52 percent of North Carolina MCC users said the MCC enabled them to qualify for a mortgage. Since that number is significantly higher than the percentage of individuals who needed the MCC to purchase

<sup>16</sup>Germany and Spain also have first-time home buyers credits, although the effects have not been rigorously studied.

a house, that suggests that many individuals used the MCC to purchase houses with tax-exempt mortgages rather than other means (Stegman and Stebbins 1992).

### E. Housing Prices

As discussed in Part V, the MID does inflate housing prices, particularly in the short and medium term, when the supply of housing cannot fully adjust. It is not clear that inflating housing prices makes sense as a policy objective. Nevertheless, it is reasonable to be concerned about the impact of sharp declines in housing prices. One way to deal with this concern might be to phase in the reduction and eventual repeal of the MID to soften the impact on housing prices in the short term.

The creation of a first-time home buyers credit is unlikely to raise housing prices by very much, if at all. That is one of the main reasons why it would be likely to raise homeownership rates. Only about 40 percent of home buyers in a typical recent year are first-time buyers.<sup>17</sup> As a result, the subsidy would target precisely the intended group — first-time buyers — while having a smaller inflationary impact on housing prices generally.

### F. Other issues

There is a risk that the FHC could reduce saving. Giving a subsidy to first-time homeowners reduces one incentive to save among the young: financing down payments on first homes. Data from the 2001 Survey of Consumer Finances indicate that, among households in which the head was under 40, 10 percent named owning a home the primary reason for saving and 17 percent named it as an important reason. By loosening the down payment constraint, the FHC will reduce the need for such saving.

The need to save to purchase a home, however, has fallen due to the growth of zero-down-payment mortgages, a pattern that is likely to continue in the future. Many lenders began offering and easing the restrictions on 100 percent home loans in the late 1990s. Fannie Mae and Freddie Mac have been purchasing mortgages with 97 percent loan-to-value ratios since 1998. The Bush administration has proposed mortgage insurance for zero-down-payment loans for first-time home buyers with strong credit records.<sup>18</sup> According to the National Association of Realtors (2006), 43 percent of first-time home buyers in 2005 did not put any money down. The median first-time home buyer used a down payment of 2 percent on a \$150,000 home. Thus, there may be little down payment savings that is potentially “crowded out” by this homeowners credit.

While the FHC may have little net effect on saving, a new plan for homeownership also offers the opportunity to significantly raise private and national saving. Our second proposal aims to raise saving at the same time that it raises homeownership.

<sup>17</sup>Authors’ calculations from the AHS.

<sup>18</sup>Office of Management and Budget (2006), p. 70.

## VII. Saving Incentives for First-Time Buyers

### A. Proposed Design

We propose a design similar to a Canadian program from the 1970s and 1980s (see Engelhardt 1996, 1997). Under our proposal, any individual who has not owned a home in the previous three years can set up a first-time home buyers saving plan (FHSP) account. Contributions would not be tax deductible. Instead, each prospective first-time home buyer would receive a 30 percent matching contribution from the federal government for contributions of up to \$5,000 per year (adjusted for inflation) placed in the account; thus, married couples could contribute up to \$10,000 per year.<sup>19</sup> The FHSP would have the same income limits, during the years when contributions were made, as the FHC. It would be available, in full, for married couples filing jointly with a combined income up to \$150,000, and others with income up to \$75,000 and phased out at a 10 percent rate for households with higher income (and so would phase out completely at income levels of \$210,000 for married couples filing jointly and \$105,000 for others).<sup>20</sup> Total contributions of \$10,000 per person could be made to the account. The funds would accrue tax free and could be withdrawn tax and penalty free if used for a home purchase. Otherwise, they could be rolled into a retirement account without tax or penalty (although the funds would be taxed as any other withdrawal from the retirement account when they are eventually withdrawn), or could be withdrawn for other purposes but subject to regular income tax and a 10 percent penalty.

### B. Effects

It is difficult to pin down the revenue and distribution effects of that program. It would almost certainly be less expensive than the MID. Depending on the year, between 13.9 percent and 15.5 percent of eligible households participated in the Canadian Registered Home Ownership Savings Plan (RHOSP) program, of whom 66.3 percent to 73.1 percent contributed the maximum amount (Engelhardt 1996). About 30 percent of all renting households are married. If 16 percent of renting households annually contributed the maximum amount, the FHSP would cost about \$11 billion per year in federal matching contributions. Additional revenue losses, which we have not calculated, would come from the deferral or elimination of tax payments on the contributed amounts. While the magnitude of that cost would depend on many factors that are difficult to measure, including details on the spending or saving that FHSP saving would replace and the marginal tax rates of contributors, rough estimates suggest that the total cost of the program would be in the neighborhood of that of the FHC.

<sup>19</sup>See Gale, Gruber, and Orszag (2006) for further discussion of the value of converting the tax deduction for contributions to tax-preferred saving accounts into a flat rate matching contribution.

<sup>20</sup>Data from the AHS (2003) suggest that more than 96 percent of renters would be eligible for the maximum benefit and more than 98 percent for some benefit.

Adopting this program in exchange for the MID would be progressive. Renters, who would be the primary beneficiaries, have significantly lower incomes than owners who benefit from the MID (Table 8). While it is likely that wealthier renters would be more likely to join a saving program, it would be highly unlikely that that would be enough to outweigh the substantial income differences by rental status and the MID's regressivity even among owners, which was discussed earlier.<sup>21</sup>

Empirical evidence on homeownership from similar programs is encouraging. Government-sponsored programs to encourage saving for homeownership are common in the rest of the world. Those programs either existed or currently exist in Canada, Germany, France, and several other countries.

The most similar program — and one that has been rigorously studied — is the RHOSP. The program allowed each individual an annual tax deduction up to a maximum of \$1,000 on savings committed to the purchase of a first home. Contributions had a lifetime limit of \$10,000, and contributed funds could have accrued for 20 years before withdrawal was required. If the RHOSP funds were not used for home purchase, the funds were included either in the taxpayer's ordinary income and fully taxed on withdrawal, or they were rolled into a tax-deferred retirement account, where the funds would be taxed fully on withdrawal. Engelhardt (1996, 1997) used program variation across provinces (because of different tax rates), over time (as the program was terminated in 1985), and between renters and owners (since only the former could benefit) to estimate the effect of the program on both homeownership and saving. He found that among renters with heads under age 45, the program raised the percentage transitioning to homeownership in a given year from 16.5 percent to 19.8 percent, a 20 percent increase. He also found that contributions to the program tended to represent net accumulations of wealth, with between 20 percent and 57 percent of contributions adding to national saving.

In the U.S., individual development accounts (IDAs) are savings accounts that receive matching contributions and are targeted to low-income households and for special purposes, such as home purchase (Sherraden 1991). By 2001-2002 more than 500 IDA programs were in operation in the U.S., serving more than 20,000 account holders. Mills, Gale, Patterson, and Apostolov (2006) evaluated a randomized IDA experiment conducted in Tulsa, Oklahoma. IDA withdrawals used for home purchase were matched at 2 to 1. Withdrawals for other "approved" uses were matched 1 to 1. Matching payments were made directly to the seller of the home. The authors found that the program had a significant effect

<sup>21</sup>Saving rates for American households tend to rise with income. See, e.g., Dynan, Skinner, and Zeldes (2004). Also, Engelhardt (1996) found that contributors to the RHOSP, discussed later, had higher incomes than eligible noncontributors. He attributed that in part to the fact that the RHOSP gives bigger advantages to those with higher marginal tax rates (that would not be true of the FHSP) and in part to higher-income individuals' higher propensity to save.

on homeownership rates of renters as a whole, raising the rate by about 6 percentage points overall. The effect was particularly strong among black renters — 12 percentage points — and was much smaller and statistically insignificant among white renters. An effect of that magnitude would be significantly larger than any losses in homeownership from repealing the MID.

### C. Comparing the FHC With the FHSP

Both the FHC and the FHSP would be less expensive, more progressive, and better able to spur homeownership than the MID. The FHC would be more progressive than the FHSP because the latter would be available only to first-time home buyers who choose to save. As mentioned earlier, those individuals are likely to be wealthier than the typical first-time home buyer. The FHC would also likely be better at promoting homeownership. Some individuals would probably use the FHSP to increase retirement savings beyond current limits, with no intention to change their home-purchasing timetable. That would reduce the program's bang for the buck in terms of homeownership rates. The major benefit of the FHSP relative to the FHC is that it would be better at promoting saving. Individuals would need to save for their down payment to access this benefit. And since some individuals will not use this money to buy a house, it would further promote retirement saving. It would also be possible to introduce both plans as a replacement for the MID, allowing each household to choose one of the two, but not both. Thus, all first-time home buyers under the income limit would receive a benefit, with those committed to savings receiving a larger bonus.

## VIII. Conclusion

Federal tax policies toward housing are inequitable, inefficient, and expensive. A straightforward way to address those issues would be to refocus on first-time home buyers the current massive resources generally given to housing subsidies. The most auspicious options include a first-time home buyers tax credit and a subsidized savings account for prospective first-time home buyers. Those options would be considerably less expensive, more progressive, and more conducive to raising homeownership than the MID.

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