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Promoting Wealth Building through Homeownership

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Abstract: Current tax policies, while commonly thought to promote homeownership, have generally left low-income homeowners behind other homeowners. Using a number of simplifying assumptions, our estimates of lifetime homeowner tax subsidies suggest that the average homeowner in the lowest-income quintile may receive cumulative tax subsidies that are roughly one-thirteenth the size of those received by someone in the highest-income quintile. From an asset- and wealth-building perspective, the tax system thus places low-income households at a very large disadvantage – both in their quest to become homeowners and in what happens after they achieve homeownership status.

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Introduction

Many families have used homeownership as a leading element in their asset- and wealth-building strategies. As an indication of this, residential real estate holdings traditionally have made up nearly 30 percent of all household assets in the United States. For younger, minority, and low-income families, homeownership may play an even more important role in supporting and improving one's financial position. According to one study, the median ratio of home equity to family net worth was 82.8 percent for homeowners in the bottom income quartile, thus indicating that lower-income homeowners have the vast majority of their wealth and financial security tied up in their homes (Belsky 2008).

While homeownership can represent an important step toward financial success, low-income households appear to face a number of constraints in using homeownership as a wealth-building strategy. In particular, low- and moderate-income households have not achieved the same levels of homeownership as other income groups. Only 46.3 percent of families with incomes in the bottom fifth of all households were homeowners in 2007 (U.S. Census 2008). This compares to an 88.7 percent homeownership rate for families with incomes in the top fifth of all households. In addition, home values and the levels of home equity for lower income households typically lag well behind other income groups, with households in the bottom quartile holding only 6.3 percent of total U.S. home equity compared to almost 60 percent held within the top income quartile (Belsky 2008).

A variety of public policies seek to promote homeownership in the United States, but it is not clear whether these policies generally work to the benefit of lower-income households.

Under federal and most state tax laws, homeowners can deduct mortgage interest and property tax payments from their taxable income. These tax savings, however, will necessarily be much greater for those in higher tax brackets and for anyone with enough tax deductions to itemize instead of taking the standard deduction. As a result, low-income homeowners are likely to receive relatively little in terms of tax benefits compared to higher-income households.

Another way that public policies may fall short in helping low-income homebuyers is that much of the focus of these policies is on expanding mortgage credit and making lending terms more creative and flexible. Although such steps may help open the door for prospective homeowners, these policies may tend to encourage excessive reliance on borrowing and, accordingly, can put low-income home purchasers at greater financial risk. A related outgrowth of such policies is that they shift even greater importance to the level of financial literacy among low-income and first-time homebuyers. The current subprime lending crisis, in fact, illustrates many of these shortfalls in public policy and indicates the need to look for alternative steps to make housing more affordable.

This paper will first look at how federal and state tax policy might affect homeownership and what research has been done on this topic. Next, the paper will examine the federal tax treatment of homeowners and how the resulting annual tax savings are distributed across different income groups. Estimates of these tax savings will then be aggregated over a homeowner's lifetime to provide some perspective on their overall contribution to asset and wealth building in different income groups. A final section will discuss several alternative approaches that could be used to encourage greater homeownership among lower-income and first-time homebuyers and thus aid such families in their asset- and wealth-building strategies.

Tax Incentives for Homeownership

Homeowners receive a number of benefits under federal and most state tax laws. First and foremost, they can take a deduction against their federal taxable income for the mortgage interest and property taxes that they pay as homeowners, provided their total itemized deductions exceed the standard deduction.¹ Furthermore, they can take these deductions without having to declare an imputed rental income to match the type of rental income a landlord would have to declare for tax purposes if the house were rented out. Under the Housing and Economic Recovery Act of 2008, the authority to take a deduction for property taxes has also been extended on a temporary basis to homeowners that take the standard deduction. These taxpayers may increase their standard deduction for 2008 by the amount of property taxes they pay up to a maximum of \$500 (\$1,000 for married couples). Many state tax laws allow essentially the same type of mortgage interest and property tax deductions for homeowners.

In addition to these benefits, homeowners may exclude up to \$250,000 (\$500,000 for married taxpayers filing jointly) in capital gains from selling a home, assuming they have lived in the home for at least two of the prior five years. Also, a \$7,500 tax credit for first-time homebuyers was included in the Housing and Economic Recovery Act of 2008. This credit applies to home purchases between April 9 and December 31 of 2008. It was originally intended to take the form of an interest-free loan that first-time homebuyers would have to repay through a \$500 addition to their tax liabilities for each of the next 15 years. However, the American Recovery and Reinvestment Act of 2009 eliminated this repayment requirement on a retroactive

¹ The mortgage interest deduction is limited to the interest on a mortgage of \$1 million or less, with addition deductions allowable on home equity loans of up to \$100,000. Property taxes are not deductible for taxpayers subject to the alternative minimum tax.

basis, and increased the tax credit to \$8,000 for first-time homebuyers that purchase a home between January 1 and December 1 of 2009.

The overall tax benefits that flow to homeowners from these provisions are extremely large. The Joint Committee on Taxation (JCT, 2008, pp. 51-52) estimates that tax deductions for mortgage interest and property taxes on owner-occupied homes, the increases in the standard deduction for property taxes paid by homeowners who don't itemize, and the exclusion of capital gains on homes will result in total tax expenditures (or a reduction in tax liabilities) of \$109.3 billion for 2008. According to the JCT estimates, these tax benefits are not only large, but they are heavily concentrated among certain groups of taxpayers. For instance, 73 percent of the tax savings from deducting mortgage interest go to taxpayers with incomes of more than \$100,000, while only about 4 percent of the savings go to those with incomes under \$50,000 (JCT 2008, p. 76).

This disparity in tax benefits between lower-income and higher-income taxpayers can be explained by a number of factors. First, higher-income taxpayers are likely to have larger and higher-priced homes, resulting in much higher mortgage interest and property tax payments to be deducted. Next, the actual value of the mortgage interest and property tax deductions will be closely tied to an individual's marginal tax rate, with the greatest tax savings flowing to those in the highest tax brackets. The ability to benefit from these deductions is also linked to whether a taxpayer has enough deductions to itemize rather than taking the standard deduction, and in many cases, lower-income homeowners may not have enough total deductions to gain much advantage from itemizing.

Under current federal tax rates, higher-income households can get back in the form of lower taxes as much as 35 percent of what they pay for mortgage interest and property taxes, while lower-income households get at most 10 or 15 percent back. Often low-income householders get nothing back because they do not have sufficient itemized deductions. Over time, these tax subsidies will enable higher-income families to afford larger homes than they otherwise could, while lower-income households are forced to pay proportionately more on an after-tax basis to finance and own a home.

A wide range of studies have looked at homeowner tax deductions and their effects in terms of economic efficiency, equity across different groups of taxpayers, and the role they are thought to play in encouraging homeownership. Several studies examine how tax benefits are distributed geographically and how they might influence metropolitan development and different income groups. According to Brady et al. (2003) and Gyourko and Sinai (2001), those receiving the largest subsidies are concentrated along the California coast and along the east coast from Washington, DC, to Boston, MA. Gyourko and Sinai also find that homeowners in suburban areas generally receive larger benefits than those in inner city neighborhoods, thus indicating that these tax subsidies are likely to be the greatest in areas with high-priced homes and high-income households. Edmiston and Spong (2007) calculated homeowner tax subsidies by individual census tracts in the Kansas City metropolitan area and then grouped these tracts according to their median income levels. They found that average tax subsidies, homeownership rates, and housing values in low-income census tracts greatly lagged behind those in higher-income tracts.

A number of other studies have analyzed the sensitivity of housing tax subsidies to either actual or potential changes in tax laws. Rosen (1979) finds that replacing existing tax deductions with a 25 percent tax credit on mortgage interest and property taxes for all homeowners would

result in greater tax savings and increased home values for lower-income households and the opposite effect for higher-income families. Green and Vandell (1999), Carosso et al. (2005), and Anderson et al. (2006) also find that tax credits for mortgage interest and property taxes would be more beneficial for low-income homeowners. In particular, Green and Vandell estimate that a revenue-neutral switch to a fixed-dollar tax credit (\$1,100 for their sample of households) would result in a notable increase in homeownership rates among minority and low-income households.

Another study, Follain and Ling (1991), examined how the Tax Reform Act of 1986 affected housing tax subsidies through its lowering of marginal tax rates, increase in the standard deduction, and elimination of several nonhousing itemized deductions. They concluded that housing tax subsidies and their deadweight losses still remained large and that the tax changes did little to improve the distribution of these tax benefits across income groups. In fact, the increase in the standard deduction and the reduction in the number of itemized deductions made mortgage interest and property tax deductions virtually worthless for many households with incomes below \$42,500.

These studies thus support the conceptual view that low-income homeowners are not likely to receive the same level of housing tax incentives as other income groups. As a result, the housing tax incentives may also do little to increase homeownership rates since the vast majority of the tax benefits probably flow to households that would be able to purchase homes without such assistance. One topic that has not been directly addressed in these studies is what the cumulative effect of these housing tax policies might be on the ability of lower-income households to build up their assets and wealth through homeownership.

Estimation of Homeowner Tax Subsidies

Distribution by Income

Our goal in this subsection is to use a sample of federal tax income returns to estimate how homeownership-based tax benefits vary across different income groups and may affect the ability of the households within these income groups to build up their assets and wealth. The estimation requires that we utilize a sample of returns to create a model of homeownership tax benefits. With this model we can directly compute tax benefits across income groups. The specific groupings we use are income quintiles and low- and moderate-income status. The low- and moderate-income cohort is made up of individuals whose income is less than 80 percent of area median income. Typically, area median income is the median income in the metropolitan area for metropolitan tracts and state median income for nonmetropolitan tracts. In this study, we used national median income for reasons of tractability. Moreover, the lowest level of geography provided in the tax returns is the state of residence.

The IRS Public Use Tax File is the primary data source for our analysis of homeowner tax incentives. The Public Use Tax File contains a sample of 145,663 tax returns, with names, social security numbers, and other identifying information removed.

The calculation of the tax subsidy generated from mortgage interest and real estate tax deductions (herein “homeowner tax subsidy,” or simply “tax subsidy”) begins by subtracting the value of the standard deduction (based on filing status) from the total deductions listed on the tax form. Taking the standard deduction is always an option for the taxpayer, so only deductions in excess of the standard deduction represent a benefit directly tied to itemizing.

$$\begin{aligned} \text{Deductions in Excess of the Standard Deduction} = \\ \text{Total Deductions (line 36 of Form 1040)} - \text{Standard Deduction} \end{aligned}$$

The average value for excess deductions is provided in Table 1 (Column 6) for each income class. For many returns, especially in lower-income ranges, the value of excess deductions was zero (because most low income filers do not itemize), and thus the tax subsidy was given a value of zero. For the remaining returns, excess deductions were compared to the

sum of real estate tax deductions and mortgage interest deductions, which we term “property deductions”:

$$\text{Property Deductions} = \text{Real Estate Tax Deductions (line 6, Sch A)} \\ + \text{Mortgage Interest Deductions (lines 10 – 12, Sch A)}$$

For tax returns in which excess deductions exceeded property deductions, the effective property deduction was the actual deduction (Table 1, Column 7). For tax returns in which property deductions exceeded excess deductions, the effective property deduction was set equal to the excess of total deductions over the standard deduction:

$$\text{Effective Property Deduction} = \min\{\text{Excess Deductions, Property Deductions}\}$$

Once the effective property deduction was calculated, the tax subsidy was computed as the product of the marginal tax rate (MTR) and the value of the effective property deduction (Table 1, Column 8):

$$\text{Tax Subsidy} = \text{MTR} \times (\text{Effective Property Deduction})$$

In some cases the effective property deduction exceeded the tax base upon which the marginal tax rate applied (which we call the marginal tax base, MTB). In these cases, the marginal tax rate was multiplied by the marginal tax base (the maximum of the current bracket less taxable income reported on the return), which was then added to the product of the remainder of the deduction and the tax rate applicable in the next highest bracket (MTR2):

$$\text{Tax Subsidy} = (\text{MTR} \times \text{MTB}) + [\text{MTR2} \times (\text{Effective Property Deduction} - \text{MTB})]$$

To illustrate, consider a couple who are married and filing a joint return with *taxable* income of \$150,000 and effective property deduction totaling \$18,000 (in the absence of the effective property deduction, the couple’s taxable income would be \$168,000). The couple would be in the 31 percent bracket in 2000, which ranged from \$105,950 to \$161,450. Thus, only the first \$161,450 – \$150,000 = \$11,450 would be taxed at the 31 percent rate (in the

absence of the deductions), and the remainder would be taxed at the next highest, 36 percent rate. The tax subsidy accruing to the couple would thus be:

$$\text{Tax Subsidy} = 0.31(\$11,450) + [0.36(\$18,000 - \$11,450)] = \$5,907.50$$

In a very few cases, a third tax rate applied, and the calculation proceeded in a similar fashion.

Column 9 of Table 1 reports the average tax subsidy rate for each income class: the tax subsidy as a percentage of the total mortgage interest and real estate taxes claimed on the tax return. These results largely reflect marginal tax rates in the respective income classes.

The calculations in Table 1 show a clear relationship between income status and the homeowner tax subsidy. The average tax subsidy for low- and moderate- income people was less than five percent of the average subsidy for higher income people in 2000. The subsidy rates are much closer, which reflects that the difference in subsidies is derived mostly from differences in the base (effective property deductions) than the marginal tax rates. Subsidies also increase markedly through the income quintiles, and in 2000, the average subsidy in the lowest-income quintile was less than one percent that of the highest-income quintile.

Figure 1, which shows the distribution of the homeowner tax subsidy by adjusted gross income (AGI) for returns showing AGI of \$20,000 – \$1,000,000, reflects a similar pattern. At the lower levels of AGI, the average tax subsidy is quite small. Most taxpayers at these income levels have low marginal tax rates and either have insufficient deductions to itemize or their itemized deductions exceed the standard deduction by very little. As income increases, the average property subsidy increases rapidly, especially to the \$100,000 AGI mark. An increase in AGI from \$50,000 to \$100,000, or 100 percent, is associated with a 463 percent increase in the tax subsidy. Past \$100,000, the tax subsidy tends to increase less than proportionately. This is not surprising since the probability of itemizing deductions at those income levels is nearly 100 percent (see Figure 2 and related discussion below). Further, only interest on the first \$1,000,000 of a mortgage is deductible.

Our next step is to estimate the value of the tax savings throughout a family's entire homeownership experience, which we assume is 30 years. We begin by identifying the median house value for each income cohort using data from the American Housing Survey. We assume that each house is purchased in January, 2009 and then build an amortization schedule for a 30-year fixed-rate mortgage. We assume a ten percent downpayment, an interest rate of 7.0 percent per annum, home price appreciation of 7.8 percent per annum (Case and Marynchenko), and a discount rate of 5.0 percent per annum. The effective property tax rate is assumed to be 1.5 percent. Results from the analysis are provided in Table 2.

Discounted to the present (column 6), middle- and high-income families have an average lifetime homeowner tax subsidy of \$91,873, or about \$78,327 more than the average low- and moderate-income family's cumulative homeowner tax subsidy of only \$13,546. The differences are even more apparent when looking at income quintiles. The highest-income quintile's average lifetime homeowner tax subsidy, again discounted to the present, is \$162,107, almost 13 times larger than the lowest-income quintile's lifetime homeowner tax subsidy of only \$12,773. By contrast, the median house value in the highest-income quintile is only about four times as large as the median home value in the lowest-income quintile.

For several reasons, this analysis may understate the tax subsidy differences between low-income and high-income families. First, higher-income families typically become homeowners earlier in their lifetimes than do lower-income families. Just over 20 percent of families in poverty where the head of household is 25 – 34 are homeowners, compared to roughly 49 percent of families who have incomes above the poverty line (Figure 2). Further, minority first-time homebuyers, who are more likely to be low-income, also tend to buy homes later in life than white first-time homeowners. About 47 percent of minority first-time home buyers are under 35 years of age, compared to roughly 66 percent of white first-time home buyers (Herbert et al., 2005). Assuming a household in the highest-income quintile continues to own a home and make mortgage interest payments for 40 years, while those in the lowest-

income quintile own a home for 30 years, the high-income household would enjoy \$36,630 in additional tax benefits beyond those shown in Table 2, or \$7,792 discounted to the present.

Secondly, incomes in the United States have been diverging over time. The ratio of the median income of the 90th percentile to the median income of the 10th percentile has grown from 8.74 in 1977 to 11.18 in 2007 (U.S. Census Bureau). The Gini coefficient, which measures inequality on a scale of 0 (most equal) to 1 (least equal), increased 0.402 in 1977 to 0.463 in 2007 (U.S. Census Bureau). As incomes diverge, so do homeowner tax subsidies. While estimates of the income elasticity of owner-occupied housing vary considerably, many estimates suggest that owner-occupied housing demand may be income elastic. In one of the more recent papers, Belsky, Di, and McCue (2006) estimate an income elasticity of owner-occupied housing demand at 1.18 (assuming only one home is owned). If this number is correct, then the value of housing increases at a greater rate than income, which should make the tax subsidies between lower-income homeowners and higher-income homeowners diverge even more. Even with an income elasticity of housing demand less than unity, there would be a divergence in dollar amounts (unless the housing demand was extremely income inelastic).

Third, homeowners often “trade-up” over their lifetimes, purchasing larger, more expensive homes. In many cases, the time to maturity of the subsequent mortgage will be greater than that of the existing mortgage, resulting in an extended time for deducting mortgage interest. More expensive homes also would likely result in higher property taxes. Further, some homeowners refinance to extract equity from their homes or take on junior liens. This interest also is deductible (within limits). The result in all of these cases is additional divergence in lifetime homeowner tax subsidies across income groups in dollar amounts, and potentially in relative terms as well, depending on the income elasticity of housing demand.

A fourth and potentially substantial factor in tax subsidy inequality is the likelihood of owning a second home, for which mortgage interest can be deducted from taxable income (with some limitations). The idea that higher income people would be more likely to own a second home is not at all surprising, of course. Among Baby Boomers, the average income of a second

home owner is \$77,120, compared to \$43,560 for households that own a single home (Engelhardt). Second home owners have *median* non-pension wealth of \$487,500, compared to \$222,000 for single home owners. The difference in *average* non-pension wealth was \$1,096,041 and \$518,849, respectively. The average second homeowner had a remaining mortgage of \$112,042 on a home valued at \$197,341. For the average household owning a second home, the additional mortgage interest and property taxes paid on that home would generate additional income tax savings of \$84,143 over a 30-year lifetime, or \$40,598 in present value.

Finally, as interest payments decline over the life of the mortgage, lower-income homeowners are likely to have total deductions that slide under the standard deduction amount, reducing their tax subsidy to zero.

Distribution by Census Tract

Because the tax subsidy varies so much by income, and income varies widely geographically, the tax subsidy varies considerably across space, even within a metropolitan area. These disparities in tax savings across metropolitan areas and between neighborhoods raise an additional concern for lower-income families and their ability to build wealth through homeownership – Will their homes be as likely to maintain their values as those in other neighborhoods and will their neighborhoods remain attractive to potential homeowners? Accordingly, this subsection examines tax subsidies by Census tract for the Kansas City metropolitan area. We also look at the effect of tax subsidies on maintaining a tax base and funding public services, which could also be another channel influencing the attractiveness and stability of neighborhood housing markets.

This analysis begins by estimating the probability that any one person itemizes deductions, based on their individual characteristics, such as marital status and income. We use data from the IRS 2000 Public Use Tax File to build predictive models of the probability of itemizing and the value of the tax subsidy (given itemization) based on characteristics of the taxpayer. We then apply the model to tract-level data from the Census. We use Census data

because we can get information at the neighborhood (tract) level, whereas the IRS data reports only the state of residence of the filer. Given the use of both types of data, we must build the model using only those variables that are available both in the Public Use Tax File and from the Census Bureau. These variables are income, marital status, minor dependents, mortgage interest payments (estimated from Census data), property tax payments (estimated from Census data), and state of residence.

The probability of itemizing, given the variables listed above, was estimated using a standard logit model. Results suggest, as expected, that the probability of itemizing increases with income, but does so at a decreasing rate (Figure 3). Married households are more likely to itemize than single households, and households with children are more likely to itemize than households without children.

The next step was to build a model for estimating the tax subsidy, conditional on itemizing. All of the factors in the logit model were also employed in the homeowner tax subsidy model, but two additional variables, mortgage interest paid and property taxes paid, were added. The estimates were weighted to reflect the stratification in the Public Use Tax File.

Estimates from the probability and tax subsidy models provided a model with which Census data could be used to estimate the tax subsidy of the typical household in each Census tract. The Census data comes from the STF3 files for the 2000 decennial census. We follow Gyourko and Sinai's (2001) methodology for creating a household income distribution for each tract. For each tract, we construct income deciles based on the distribution of households by the income groups reported in the Census. A representative household from each decile is determined as the median of the decile. Thus, for each tract, we utilize ten representative households in the analysis: one representing the 5th percentile, the 15th percentile, the 25th percentile, and so on. Each representative household is assigned a house value using a similar methodology. The household representing the 5th percentile in the income distribution is assigned the house value at the 5th percentile of the distribution of house values in the tract.

Income for each tract-decile household was incorporated into the models to begin the computation, as was an accounting for the state of residence (Missouri or Kansas in our analysis). For each tract, shares of the household population that are single and married and with and without children present were assumed to be constant across deciles, and these values also were incorporated into the models.

For the annual mortgage interest payment (mi), we follow Gyourko and Sinai (2001) and set $mi = (HV)(\lambda)(i)$, where HV is house value for a representative decile household in the tract from the 2000 Census, λ is the estimated loan-to-value ratio in the tract, which is based on the tract's age distribution and data from the 1998 Survey of Consumer Finances, and i is a weighted average mortgage interest rate, which is also based on the age distribution in the tract and data from the 1998 Survey of Consumer Finances (adjusted to 2000-level interest rates).

To calculate property taxes, we collected data on property tax collections for counties, municipalities, school districts, and special districts (such as library, fire, or water districts), from the 2002 Census of Governments. For each level of geography, we then computed the average property tax payment per household. The effective property tax rate for the area was applied to the median house value in each decile in each individual tract within the area to generate an estimate of the average property tax payment per household.

Calculations of the homeowner tax subsidy for the Kansas City metropolitan area reveal wide variation across Census tracts (Figure 4). The mean value of the tax subsidy in Kansas City tracts is \$923 per household, but the median is only \$585, again implying a relatively skewed distribution. The standard deviation across tracts is \$969. The average tax subsidy ranges from zero to as high as \$5,842. Those living in relatively low-income, minority tracts on the Missouri side in the center of the map receive very minimal tax subsidies, on average, while those in the mostly white, high-income neighborhoods to the southwest on the Kansas side (Johnson County) receive average tax subsidies in the thousands of dollars. The income distribution in the Kansas City metropolitan area is highlighted in Figure 5.

Most of the variability in average tax subsidy across tracts arises from differences in income, homeownership rates, and house values (Table 3). In low-income tracts in Kansas City, defined as tracts where the median income is less than 50 percent of the MSA median income (\$46,192), the homeownership rate is less than 40 percent. For those who do own their home, relatively little deductible mortgage interest is likely paid because the median house value in the tract is only \$47,673 and few households have sufficient deductions to itemize. Because of these low homeownership rates and home values, and a median income of only \$19,288, the average tax subsidy in these tracts is a negligible \$256.

Now consider the statistics in high-income tracts, those where the median income exceeds 120 percent of the MSA median. The median income is \$74,064 in these high-income Census tracts, the homeownership rate is 84.2 percent, and the median house value is \$168,827. Subsequently, the average tax subsidy is a considerably larger \$1,944. As a result, the current tax framework provides a substantial homeownership incentive in high-income neighborhoods in the Kansas City area, but does little to encourage homeownership in lower-income neighborhoods.

In addition to providing less incentive for homeownership in lower-income neighborhoods, the current income tax regime has an important secondary effect of reducing the level of local public services in lower-income areas vis-a-vis higher-income areas. With regard to public services, there are two channels through which intrametropolitan differences in federal homeowner tax deductions might exert an influence on the provision of local public services.

First, the deductions (as well as other housing subsidies) should lead to higher property values. Because homeowners recognize that they receive a subsidy for mortgage interest and state and local property taxes, they spend more on housing than they would in the absence of the subsidy. When income increases, housing consumption tends to increase. Since these subsidies are the greatest for those in higher tax brackets and with more itemized deductions, this effect is strongest for those with the highest incomes. As a result, homeowner tax deductions can be

expected to contribute to higher housing values, particularly in higher-income neighborhoods, and to a better tax base to support public services.

A second effect comes directly from the ability of homeowners to deduct property taxes. A homeowner's property taxes, along with any state and local sales, income, or user fees, represent the price that the homeowner pays for public services and infrastructure. As a result, the deductibility of property taxes reduces the after-tax price of public services for those who can itemize. The price of public services, for example, is reduced by a percentage equal to the effective marginal tax rate for those who are able to fully deduct property taxes. Consequently, high-income neighborhoods are able to purchase public services more cheaply than lower-income neighborhoods.

Housing is highly segregated by income. Thus, the result of current housing tax policy is both an increase in the property tax base in communities where those with high-incomes and with substantial mortgage interest and property tax deductions typically reside and a decrease in the after-tax cost of providing public services. This, in turn, means that public services can be provided more readily and more cheaply in higher-income neighborhoods than in lower-income neighborhoods.

Most local public services are financed through local property taxes, so a higher property tax base and a lower after-tax cost of supporting this tax base will lead to a greater provision of public services or to lower tax rates for the same level of services. The implication is that through the mortgage interest and property tax deductions, the nation as a whole subsidizes the provision of local public services and infrastructure in higher-income areas. In the longer term, lower-income communities become less and less attractive relative to high-income communities, which leads to more decline in low-income neighborhoods and even more expensive public services.

Using data from school districts in the State of Missouri, we (Edmiston and Spong (2009)) have found that disparities in homeowner tax subsidies do indeed lead to disparities in

the provision of local public services. Specifically, we estimate that a 100 percent increase in the average homeowner tax subsidy yields a ten percent increase in local spending per student.

These disparities in tax subsidies across neighborhoods and their secondary contribution to disparities in public services suggest that lower-income neighborhoods may face a number of added challenges not experienced in higher-income neighborhoods. For homeowners in lower-income neighborhoods, these challenges may leave additional roadblocks to wealth-building through homeownership.

Alternative Approaches to Wealth Building for Low-Income Homeowners

The above analysis indicates that lower-income homeowners receive only modest benefits under federal tax laws, particularly in comparison to middle- and high-income homeowners. As a result, most of the benefits are skewed towards individuals that already have the financial resources to become homeowners, and very little of this tax assistance appears to be directed toward those that face the greatest challenges in becoming homeowners and are most in need of a sound and workable wealth-building strategy.

There are a number of policy alternatives that potentially could help increase low-income homeownership and wealth building opportunities. The most commonly discussed alternatives are to (1) replace the current set of homeowner tax deductions with a homeowner tax credit, (2) create first-time homeowner grants or downpayment assistance, and (3) develop new mortgage instruments that provide a better match between a homeowner's mortgage payments and income. In comparison to current policy, these alternatives can be evaluated according to several factors, including whether they represent an improvement in the structure and affordability of mortgage payments, are likely to increase homeownership rates, enable first-time homebuyers to step in at

an earlier stage and at less risk, and provide a better path toward building up household assets and wealth.

Homeowner tax credits

One way that has been suggested to provide a more even and equitable set of incentives for homeownership is to replace the current deduction for mortgage interest with a tax credit. The advantage of a tax credit is that it could be made available to all homeowners rather than just to those that can itemize under the existing system. Also, if a tax credit were to be set at a fixed percentage of mortgage interest expenses or at fixed dollar amount, the benefits would be distributed more evenly across taxpayers.

In its 2005 Report, the President’s Advisory Panel on Federal Tax Reform recommended replacing the current tax framework with a “Home Credit” available to all homeowners and equal to 15 percent of the interest paid on a principal residence.² The Advisory Panel also recommended putting an upper limit on the amount of this tax credit, with this limit based on the average cost of housing within a region. For example, the Panel recommended that the tax credit could be capped at an amount representative of a home valued at 125 percent of the median sale price in the region. The Panel’s stated purpose in proposing this cap was “to encourage homeownership without subsidizing overinvestment in housing” and to “encourage homeownership, not big homes.” To be fair to homeowners who have already purchased homes, the Panel also recommended phasing in the tax changes over a five-year period for preexisting mortgages.

² See Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System, Report of the President’s Advisory Panel on Federal Tax Reform (November 2005).

Several studies have looked at real estate tax credits and have generally concluded that such credits would shift more of the tax benefits toward low-income homeowners and would encourage greater homeownership rates among such households (Green and Vandell (1999) and Carosso et al. (2005)). In particular, Green and Vandell calculated that a “revenue-neutral” tax credit of \$1,100 would increase the homeownership rate among minorities by 8.4 percentage points. They also estimated that homeownership rate would increase by 7.9 percentage points among their lowest-income group (households with income under \$20,000 according to 1990 Census data). Green and Vandell, however, caution that these changes in homeownership rates assume there are no financing and wealth constraints that would prevent the “new” homeowners from gaining access to mortgage financing or having enough savings for a downpayment.

--- In the final version of this paper, we will add an estimate of the tax savings by different income groups under a tax credit and then compare that to the tax subsidies we have estimated under the current tax laws ---

Overall, tax credits would appear to be an effective way to help increase homeownership rates among low-income households. By leading to greater tax savings and a somewhat higher after-tax income for lower-income households, tax credits could also provide an additional source of funds for meeting mortgage payments. In terms of wealth building, tax credits would help enable more low-income households to become homeowners and thus begin using this opportunity and the added annual tax savings to add to their assets and wealth. Over many years

of homeownership, our estimates and those of other researchers indicate that these estimated annual tax savings could add up to a substantial amount.

First-time homeowner grants or downpayment assistance

Another suggestion for increased homeownership is to provide grants or downpayment assistance to first-time homebuyers, while cutting back on tax deductions for mortgage interest and property tax payments. Grants or downpayment assistance would clearly provide the most direct way to assist first-time homebuyers and enable them to become homeowners at an earlier stage. It would also provide a real impetus to wealth building among low-income households and could help reduce borrowing needs for homebuyers and the financial exposure they face.

There are several examples of where this type of approach is being used. Australia, for instance, introduced a first-time homeowner grant in 2000. This grant of \$7,000 in Australian dollars (over \$4,500 in US dollars as of February 2009) was introduced by the Australian federal government to make buying homes easier for Australian citizens. Most first-time homebuyers can qualify for this grant, and it can be used as a downpayment, if the lender permits, or to cover insurance, real estate fees and other costs of purchasing homes. The grant is available to all applicants regardless of their incomes and the recipient must live in the home that is being purchased. This grant and other economic factors have helped bring homeownership rates to an all-time high in Australia. To provide further support to housing in the current environment, the Australian government announced an increase in this first-time homebuyer grant for homes purchased between October 2008 and June 2009. During this period, first-time homebuyers can receive \$14,000 in Australian dollars for the purchase of an established home or \$21,000 for purchasing a newly constructed home.

In the United States, the Housing and Economic Recovery Act of 2008 introduced a \$7,500 tax credit for first-time homebuyers. This tax credit initially took the form of an interest-free loan, which the homebuyer was to repay through additional taxes over the next 15 years. However, the American Recovery and Reinvestment Act of 2009 removed this required repayment. This act also provided for this first-time homebuyer credit to be extended from January 1 to December 1 of 2009, with the amount of the credit raised to \$8,000. A number of states have also experimented with plans to help provide downpayment assistance or to lend funds for downpayments that could be forgiven under certain circumstances.

Alternative mortgage instruments

The recent subprime lending collapse has pointed out the need for better-designed mortgage instruments for low-income homebuyers -- most specifically, home loans without substantial jumps in payments and without large prepayment penalties. Recent revisions to the regulations implementing the Home Ownership and Equity Protection Act of 1994 may help to address some of these concerns and restore a borrower's repayment ability as the critical element in any mortgage lending decision. Better-designed tax incentives or downpayment assistance for low-income homebuyers could also help in putting these households at less financial stress and attracting lenders and investors back to this market.

Conclusion

Current tax policies, while commonly thought to promote homeownership, have generally left low-income homeowners behind other homeowners. Using a number of simplifying assumptions, our estimates of lifetime homeowner tax subsidies suggest that the

average homeowner in the lowest-income quintile may receive cumulative tax subsidies that are roughly one-thirteenth the size of those received by someone in the highest-income quintile.

From an asset- and wealth-building perspective, the tax system thus places low-income households at a very large disadvantage – both in their quest to become homeowners and in what happens after they achieve homeownership status.

Such alternative policies as tax credits for mortgage interest payments, grants or downpayment assistance, or better mortgage lending instruments would likely be of greater help to low-income homebuyers. The effects of the existing tax framework, though, have become deeply embedded or capitalized into housing markets and have created a strong support group for continuing current policies. Our analysis provides some indication of how these effects are distributed across homeowners and neighborhoods and what avenues could be used to begin providing greater support to lower-income homeownership and wealth building.

TABLES

Table 1

Average Mortgage Interest and Property Tax Deduction Subsidy

by Income Class, 2000

Income Class	Income	AGI	Total Deduction (including Standard deduction)	Mortgage Interest and Property Tax Claimed	Total Deduction less Standard Deduction	Mortgage Interest and Property Tax Deduction (Effective)	Tax Subsidy	Subsidy Rate (%) (8) / (5)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Low and Moderate Income								
Low and Moderate Income (LMI)	17,556	16,777	5,984	757	659	478	75	9.9
Non LMI	108,426	100,835	16,517	7,085	9,903	5,992	1,668	23.5
Income Quintiles								
Income Quintile 1	10,971	10,455	5,419	324	227	196	30	9.3
Income Quintile 2	31,875	30,162	7,281	1,606	1,618	1,020	161	10.0
Income Quintile 3	50,164	47,834	9,866	3,538	3,535	2,455	452	12.8
Income Quintile 4	74,177	71,919	13,345	6,375	6,603	4,997	1,183	18.6
Income Quintile 5	233,603	213,142	29,900	13,488	22,997	12,561	4,025	29.8

Note: All data are averages for the income class.

Source: Authors' Tabulations from IRS 2000 Public Use Tax File

Table 2
Cumulative Homeowner Tax Subsidies (30 Years)

Income Class	Home Value	Loan Amount	Payment (P+I)	Cumulative Tax Subsidy	Cumulative Tax Subsidy Discounted to the Present
(1)	(2)	(3)	(4)	(5)	(6)
Low and Moderate Income Status					
Low and Moderate Income	\$98,602	\$88,742	\$590.40	\$28,076	\$13,546
Middle and High Income	\$281,723	\$253,551	\$1,686.88	\$190,416	\$91,873
Income Quintiles					
Income Quintile 1	\$98,972	\$89,075	\$592.62	\$26,473	\$12,773
Income Quintile 2	\$132,384	\$119,146	\$792.68	\$38,076	\$18,371
Income Quintile 3	\$160,853	\$144,768	\$963.14	\$59,218	\$28,572
Income Quintile 4	\$194,753	\$178,878	\$1,190.08	\$106,326	\$51,301
Income Quintile 5	\$392,000	\$352,800	\$2,347.19	\$335,982	\$162,107

Source: Authors' tabulations from IRS 2000 Public Use Tax File

Table 3
Tract Statistics, Kansas City Metropolitan Area

Tract Type	Median Income (\$)	Median Home Value (\$)	Home Ownership Rate (%)	Tax Subsidy (\$)
Low Income	19,288	47,673	38.9	256
Moderate Income	30,537	59,094	53.6	350
Middle Income	45,845	98,632	68.6	734
High Income	74,064	168,827	84.2	1,944
Note: All dollar amounts are averages				

FIGURES

Figure 1

Average Mortgage Interest and Property Tax Deduction Subsidy, 2000

by Adjusted Gross Income, AGI \$20,000 – \$1,000,000

Source: Authors' calculations using the IRS 2000 Public Use Tax File

Figure 2

Housing Tenure by Age and Poverty Status

Source: Authors' calculations from U.S. Census Bureau Data

Figure 3

Probability of Itemizing, by Income

Figure 4

Average Homeowner Tax Subsidy, Kansas City MSA,
by 2000 Census Tract

Figure 5

Kansas City MSA Income, by 2000 Census Tract

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