How to Expand Homeownership for More Americans

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For the past decade, America's homeownership rate has steadily declined, especially for young families. Because families cannot afford to buy homes, the housing industry is now in its worst slump since World War II. Last year witnessed only 990,000 housing starts. Projections for this year aren't much better.

In his recent State of the Union address, President Bush proposed giving tax breaks to help families buy their first home. That's an excellent idea. But wealthy families don't need a tax break to afford a house; working-class families need a bigger tax break than more affluent households. It is important to craft a cost-effective policy that will increase demand for homes among those who, without government help, can not afford to buy.

The President's two-year flat $5,000 tax break is wide of the mark. Jane Gravelle, a Congressional Research Service tax expert, estimated that only 1 percent of all taxpayers would benefit from Bush's plan; one-half of them would be in the top 20 percent of the income spectrum. Not only does it fail to target the help to those who need it, but it leaves in place the most inefficient housing subsidy of all--the so-called "mansion subsidy." Instead, Bush and Congress should eliminate the current homeowner deduction and substitute a progressive tax credit for homeowners. This is a more efficient, fair, and pro-business approach than the current system.

Most Americans think that federal housing assistance is a poor people's program. In fact, less than one-fifth of all low-income Americans receive federal housing subsidies. In contrast, more than three-quarters of wealthy Americans--many living in mansions--get housing aid from Washington. Hence, the existing approach is dubbed "the mansion subsidy," subsidizing people who can afford to buy homes without it.

In general, American homeowners do not believe they live in "subsidized" housing. But in fact, the federal tax code allows all homeowners to deduct all property tax and mortgage interest from their income taxes. Whether this is labeled a "subsidy" or (in the words of a new Joint Taxation Committee report) a "tax expenditure," this homeowner deduction cost the federal government over $47 billion in 1991 alone.

WHO GETS THE CURRENT HOMEOWNER SUBSIDY?

The homeowner deduction is a government subsidy that goes primarily to the affluent. Those with the highest incomes and the most expensive homes get the largest subsidy. An analysis of data recently released by the Joint Taxation Committee (JTC) shows that about one-third of the $47 billion homeowner subsidy goes to the 3.8 percent of taxpayers with incomes over $100,000. About 12 percent of this subsidy goes to the wealthiest 1 percent of taxpayers with incomes over $200,000. Over half of these tax breaks (51.6 percent) goes to the 8 percent of taxpayers with annual incomes over $75,000. Over 81 percent goes to the 20 percent of taxpayers who earn over $50,000 (see Table). (Table omitted)

Wealthy households are most likely to own homes and to itemize deductions. Half of all homeowners do not claim deductions at all. Tenants, of course, don't even qualify. As a result, over 80 percent of households with incomes above $200,000 receive a homeowner tax break, while less than one percent of households below $10,000 get this subsidy. Only 23.4 percent of the 28.8 million households with incomes between $30,000 and $50,000 receive any homeowner subsidy, and what they get, on average, is quite meager. According to economists James Follain and David Ling, for homeowners who do not have sufficient nonhousing deductions to itemize deductions, "the mortgage interest and property tax deductions become worthless."

Consider, for example, a family earning $25,000 buying a home that cost $183,590--the median home price in Boston in 1989. Assuming a thirty-year fixed mortgage at 9.81 percent (the average for that year), total annual housing expenses, before income taxes, come to $19,971. With the homeowner deduction, that family earning $25,000 would receive a tax saving of $1,214 (just over 6 percent of its annual housing costs). A family with a $75,000 income buying the same home would get a tax saving of

$2,756, or 14 percent of their housing costs. A family earning $125,000 would get a saving of $3,836, or 19 percent of annual housing costs. Thanks to the homeowner deduction, the wealthier family actually pays less for the same house. And in reality, the wealthier family is likely to purchase a more expensive home than its less affluent counterparts, getting an even larger tax savings, thus compounding the inequity.

In other words, our nation's housing subsidies disproportionately benefit homeowners with high incomes and with more than one home. The Washington Post reported that Senator John D. (Jay) Rockefeller of West Virginia receives a tax subsidy worth about $223,000 a year on his $15.3 million Washington mansion. This amount would provide rent subsidies for about fifty low-income tenants.

Overall, less than one-fifth of the nation's low-income households--those who live in a subsidized apartment building, receive a rent voucher, or get a homeowner tax break--receive any federal housing assistance. This represents the lowest level of any industrial nation.

Still, because the press and public officials focus more attention on federal aid to the poor, these programs--such as public housing and rent subsidies--are much more visible than the hidden tax subsidies to the wealthy. So while the nation's housing programs for the poor have been slashed, few Americans worry about getting the wealthy off welfare.

The Bush Administration has continued the Reagan-era policy of dismantling federal housing programs for the poor, while preserving the homeowner subsidy for the rich. Since 1980, housing assistance has been slashed by 73 percent (from $33 billion to $10 billion, the largest cut of any domestic program), while the homeowner deduction more than doubled (from $22 billion to $47 billion). In other words, the homeowner deduction is currently almost five times resident Bush's HUD Department of Housing and Urban Development) budget for low-income housing. Moreover, the JTC projects that the homeowner subsidy will reach $65.2 billion by 1995.

Despite this inequity, the Bush administration has sought further cuts in federal low-income housing aid, while sparing the nation's largest housing subsidy that primarily benefits the rich.

The homeowner deduction has serious drawbacks. Many experts realize that it was never designed to be the costly element of housing policy that it has become. When the tax code was enacted in 1913, it made some sense to allow taxpayers to deduct mortgage interest, because they used personal debt to finance small businesses and family farms. According to Professor Marc Weiss of Columbia University, who is writing a book on the history of homeownership, the deduction grew almost by accident, at first small and little noticed.

By the time the Brookings Institution economists began suggesting in the 1960s and 1970s that the homeowner deduction was inequitable and unnecessary, the real estate industry was already declaring it sacrosanct. The industry argues that the homeowner tax break is the linchpin of the American Dream. Without it, they claim, many Americans--including many young families--could not afford to purchase a home.

How important is the homeowner deduction, anyway, in promoting homeownership? Neither Canada nor Australia have a homeowner deduction, and their homeownership rate is about the same as the United States. About two-thirds of all households own their own homes.

If anything, the deduction has helped push housing prices artificially up, because homebuyers include the value of the tax subsidy in their purchase decision. It provides upper-income homebuyers with a tax shelter, encouraging them to buy bigger, and more, homes than they need. And it certainly fueled the past decade's wave of housing speculation and the conversion of affordable apartments into expensive condominiums, promoting the gentrification of many urban neighborhoods and the chaos in the savings and loan industry.

THE FADING AMERICAN DREAM

Everyone supports the "American Dream" of homeownership. Every president since Herbert Hoover has made homeownership a fundamental part of this nation's promise of prosperity. In the postwar period, the rate of home-ownership rose steadily for three decades, from 44 percent of all households in the late 1940s to 65.6 percent in 1980. Cheap suburban land, subsidized highway construction, and rising income all contributed to the postwar boom. But much of that increase was due to federal housing programs, particularly long-term low-interest, high-leverage mortgages insured by the Federal Housing Administration or guaranteed by the Veterans Administration.

In the past decade, however, the American Dream has been slipping away as housing prices skyrocketed, household incomes failed to keep pace with inflation, and federal housing programs were cut.

Throughout the 1980s, a number of studies by liberal groups like the National Low-Income Housing Coalition and the Children's Defense Fund, academic centers like Harvard's Joint Center for Housing Studies, and business publications like Fortune and the Harvard Business Review--warned of the widening gap between family incomes and housing prices, and such consequences as labor shortages in high-cost regions, homelessness, overcrowding, and declining homeownership.

A recent Bureau of the Census study, "Homeownership Trends in the 1980s," confirms these warnings. It reports that the nation's overall homeownership rate fell from 65.6 percent in 1980 to 63.9 percent in 1989. This change may not seem particularly disturbing until one looks at the figures for different age cohorts--particularly the key homebuyer years for young families. The homeownership rate for Americans age 25 to 29 fell from 38.6 percent to 35.3 percent from 1982 to 1989. For those between ages 30 to 34, homeownership declined from 57.1 percent to 53.2 percent. In the 35-to 39-year-old category, it dropped from 67.6 to 63.4 percent.

Another new Census Bureau study, "Who Can Afford to Buy a House?" explains these trends by reviewing data on housing costs and family income. According to this report, 48 percent of American families (excluding unrelated individuals) could not afford to buy the median-priced house in the region where they live. In terms of race, 43.3 percent of whites, 76.6 percent of blacks, and 74.2 percent of Hispanics are shut out of the homebuying market. In terms of age, 71.2 percent of families headed by a 25-to 34-year-old, and 47.2 percent of families in the 35 to 44 age category, cannot afford to buy a home. These figures include both existing owners and renters, but when these categories are broken down, the figures are even more revealing. Over one-third of existing homeowners could not afford to buy a home if they were looking to purchase a house today. Perhaps the most startling finding is this: 91 percent of all current renter families cannot afford to buy a home. (The figure for both black and Hispanic renters is 98 percent).

Another new study by the Joint Center for Housing Studies at Harvard University found that the current housing recession has not fundamentally altered this problem, because "housing costs as a share of income remain high by historical standards," particularly for renters seeking to purchase a first home.

The major obstacle to homeownership is the widening gap between income and housing prices. (In 1990, the median sales price for a new home was $122,700.) High interest rates contribute to the dilemma by making monthly housing costs beyond the reach of most Americans. This is compounded by the sizable downpayment required for purchase; most families simply don't have the savings.

Government policy can certainly do something about these homeownership hurdles. It can help reduce the cost of new housing by eliminating suburban "snob zoning" laws that require minimum lot sizes for homes and drive up the cost of land. The average price of a residential lot has increased 813 percent in the past 20 years, from $5,200 in 1969 to $42,300 in 1989; more than half of that increase occurred in the last five years alone. A few states--most notably New Jersey and Massachusetts--have enacted laws that either outlaw the use of local zoning to keep out affordable housing or penalize communities that do so. The New Hampshire Supreme Court recently struck down a snob zoning law in the small town of Chester, paving the way for a dramatic change in that state's housing market. HUD Secretary Jack Kemp recently unveiled a report (Not In My Back Yard) identifying exclusionary zoning as a major barrier to the construction of affordable housing.

In terms of financing barriers, it was FHA and VA mortgages--with low downpayments and bargain-basement interest rates that helped trigger the post-war homeownership boom. A similar program could do so again. According to the Census analysis, with FHA insurance--allowing buyers to spend a slightly higher percentage of their income on housing payments, finance part of their closing costs, points, and mortgage insurance, and put only 5 percent as a downpayment--an additional two million American families could qualify to buy the median-priced home in their region.

GROWING PUSH FOR REFORM

No one wants to eliminate homeowner subsidies for working-class and middle-class families, but the current system--that subsidizes the rich to purchase huge homes without helping working-class and middle-class families who do not itemize their deductions--is in desperate need of reform.

New political and economic realities have given new life to the debate over homeowner tax subsidy. There is now a growing push for reform from a variety of quarters.

Some budget-cutters see the tax subsidy as a way to address the expanding federal deficit. Others, noting the increase in homelessness and the decline of homeownership among middle America, look at the mansion subsidy in terms of equity.

Opposition to the current approach now comes from all corners of the political spectrum.

"Is the Mortgage Interest Deduction Sacred?" asked the headline on the cover of the March 20, 1989 issue of Forbes magazine. Inside, veteran Congressman Sam Gibbons, a liberal Democrat from Florida, told Forbes: "I have no objections when the deduction goes for houses. When it goes for castles, I do."

Anthony Downs, the widely respected middle-of-the-road real estate economist at the Brookings Institution, agrees:

(H)omeowner tax benefits provide enormously disproportionate aid to high-income taxpayers, even though they need such aid least. Reducing only part of the amount of assistance they receive would make substantially more funds available for housing assistance to low-income taxpayers without increasing federal deficits. It would also increase the equity of housing assistance considered as a whole. By reducing homeownership tax benefits less than 20 percent--and taking almost all of that reduction from high-income households--the United States government could probably pay for a housing voucher entitlement program serving all eligible very-low-income renter households who applied.

Austin Fitts, an investment banker who served as Bush's FHA (Federal Housing Authority) Commissioner from 1989-90, recently told the National Journal why homeownership was on the decline: "Middle-class families are too busy paying people to live in mansions in Chevy Chase, second homes in Malibu, and empty office buildings everywhere."

Fitts served on a Task Force on Affordable Housing sponsored by the mainstream Twentieth Century Fund. Their report, More Housing, More Fairly, released last November, recommends "shifting federal (housing) commitments to make current allocations fair," in particular the tax expenditures for housing.

"The HUD scandal pales in comparison to the way we allocate federal housing subsidies through the tax code," says Steve Kest, director of the Association of Community Organizations for Reform Now (ACORN), a national advocacy group. "Each year we have to fight Congress to give us pennies for housing, while Congress allows wealthy homeowners to get money just by filling out their tax forms."

Observed Charles E. McLure Jr., an economist who designed the Reagan Administration tax reform policy: "Even if one grants the case for substantial tax preferences for owner-occupied housing, it is impossible to justify this distributional pattern of benefits."

Michael Gartner, President of NBC News, recently wrote a column in USA Today (December 26, 1991) arguing that giving affluent people tax breaks for their second homes "seems absurd" when we don't even offer help to economically pinched families to send their children to college. "It's nice," he writes, "that the government wants me to buy a condo in the Rockies or a house at the beach, but that's not going to make this a strong nation."

RECOMMENDATIONS FOR REFORM

Each year, the Congressional Budget Office (CBO) publishes a massive report entitled, "Reducing the Deficit: Spending and Revenue Options," chock full of ideas, including two ways to reform homeowner tax breaks. Both recommendations (which are routinely ignored by Congress) preserve the benefits for the broad middle-class, close tax loopholes for the wealthy, and generate significant tax savings.

Their first recommendation calls for eliminating deductions for second homes. This would add only about $300 million annually in new federal tax revenues in 1993, increasing by about $100 million a year. This proposal would run into a political buzzsaw, particularly from Congresspersons from vacation-industry strongholds like Florida, Maine, and Colorado, where builders, bankers, and realtors thrive on second homes. But it seems fair considering how many Americans can't even afford to buy their first home.

The CBO's second suggestion is to limit mortgage interest deductions to $12,000 per single return or $20,000 per joint return, adjusted for inflation. These ceilings are higher than the deductions now taken by nearly all homeowners; it would affect less than 2 percent of all taxpayers. This cap would allow homeowners to take deductions on mortgages as large as about $216,000. According to the CBO, it "would retain the basic incentive for homeownership, but would not subsidize the luxury component of the most expensive homes and vacation homes." The affluent would continue to buy large homes, and second homes, but the prices would reflect their real market value, rather than the artificial price that includes the government subsidy. Last year, the CBO estimated that this reform would generate an additional $1.7 billion in 1993 alone.

In a similar vein, the Twentieth Century Fund's More Housing, More Fairly report suggests capping the homeowner deduction at 15 percent, "rather than allowing it to be worth 31 percent for wealthy families and 15 percent for poorer ones." This would save $15 billion a year--affecting only the richest 2 percent of all households--which the Fund suggests redirecting to provide subsidies for more needy Americans.

Some housing advocates want to phase out the deduction entirely for the wealthy. If the 1.1 million taxpayers with incomes over $200,000 (1 percent of all taxpayers) were no longer eligible for homeowner tax breaks, the federal government would net an additional $5.4 billion a year.

A PROGRESSIVE TAX CREDIT FOR HOMEOWNERSHIP

These reforms eliminate the subsidies for the wealthy, and yield substantial tax savings (thus helping reduce the deficit), but they do nothing to expand homeownership or otherwise meet the housing needs of the nonaffluent. Housing advocates, of course, correctly believe that any tax savings from reforming the homeowner subsidy should be targeted for low-income housing. But the way Congess operates--with its tax-writing and budget committees operating on separate paths--makes it difficult to transfer savings from capping the homeowner deduction into the HUD budget. If a similar outcome could be accomplished within the tax-writing system, however, the political path will be much easier.

We suggest scrapping the homeowner deduction entirely and trying an entirely new approach--a progressive tax credit for homeownership. This approach would encourage homeownership more effectively than the mortgage deduction.

Housing demand is more elastic at the lower and middle parts of the economy than among high-income households. As a result, a progressive tax credit would make the difference between renting and owning for millions of poor and working-class families now shut out of the American Dream. It would be available to all families--including those low-and moderate-income households that do not itemize their deductions and so cannot take advantage of the current tax break. Analyses of tenure choice, looking at the relative aftertax costs of renting and owning, demonstrate that a well-crafted tax credit can significantly increase both overall rates of homeownership, and, specifically, homeownership rates for working-class and middle-class households.

Capping the credit (for example, at the $12,000 and $20,000 levels recommended by the CBO), and tying it progressively to income (so that working-class buyers receive a larger tax credit as a percentage of income), would limit subsidies for the wealthy. They would continue to purchase homes with or without a tax subsidy. Thus, a tax credit would be much more efficient, and more fair, than the current approach.

Moreover, by increasing the effective demand for homes by poor and working-class families, a homeowner tax credit system would actually help the homebuilding industry (as well as brokers and mortgage lenders), and thus create jobs, and add to local tax bases. The housing industry is now in its worst slump since World War II. Indeed, it would help shift the discussion of federal housing policy from its current image as a "social welfare" program to the more mainstream perspective of being a way to stimulate economic recovery. According to the National Association of Home Builders the construction of one million single-family homes generates 1.75 million worker-years of employment in construction and construction-related industries; $45.7 billion in wages; $18.8 billion in combined federal, state, and local tax revenues; and considerable ripple (multiplier) effects throughout the economy.

A homeowner tax credit should appeal to major constituencies across the spectrum, including liberals, (because it will eliminate welfare for the rich while helping the working class achieve homeownership), and labor unions (because it will stimulate homebuilding, jobs, and economic recovery).

The housing industry should embrace this approach, because it will help builders, bankers, and brokers out of the current slump. A top official of one of the housing industry's major lobby groups agreed with this assessment. He observed, however, that some members of his trade association might oppose a homeowner tax credit because many of them are wealthy individuals who receive huge subsidies for their large homes.

POLITICAL OBSTACLES TO REFORM

The biggest obstacle to reform is the real estate industry. While the industry expresses concern over government policy on a variety of issues, it reserves its heavy political firepower for protecting the homeowner deduction.

The political action committees of the National Association of Realtors (the nation's largest contributor), the National Association of Homebuilders, and the Mortgage Bankers Association have a vast local network and deep pockets. Few Congresspersons want to offend these generous campaign contributors or be labeled as anti-homeownership.

For example, in 1984, at a question-and-answer session before the National Association of Realtors, President Reagan said that everything, including the homeowner deduction, was on the table as his administration pursued a complete overhaul of the tax system. But under intense pressure from the real estate lobby, especially during an election year, Reagan backed away the very next day, affirming his support for the homeowner deduction.

The industry got a big scare a few years later. In 1986, Congress limited the deduction to mortgage interest on just two homes. The next year, it capped the subsidy at $1 million of mortgage interest payments. These moves frightened the housing industry, which then mounted a major campaign to protect the homeowner tax break from further tampering by Congress. The real estate lobby groups made the homeowner deduction the litmus test for their support. The industry initiated a nonbinding resolution, sponsored by Rep. Marge Roukema (a Republican who represents the affluent New Jersey suburbs) and Rep. Les AuCoin (a Democrat from lumber-intensive Oregon), in support of protecting the existing homeowner tax break. Over half the members of the House of Representatives (including many liberal Democrats) signed on. In addition, the housing industry recently helped create a front group, called the United Homeowners Association, to lobby to protect the homeowner deduction.

Soon after taking office, President Bush, speaking at the Realtors annual convention, vowed to defend the existing homeowner subsidy. The opposition of the Bush Administration and the real estate industry to reforming the homeowner tax deduction is shortsighted. The alternative approach--a progressive tax credit would actually be more effective at achieving their goals--homeownership, homebuilding, and economic recovery.

There is a growing consensus that the nation's housing system isn't working for the millions of other poor and working-class families who cannot afford market-rate rents or home prices. The current way we distribute housing subsidy funds is wasteful and unfair.

Let's stop subsidizing the rich to live in mansions and assist working-and middle-class families achieve the American Dream of homeownership.