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**Developing Effective Subsidy Mechanisms for
Low-Income Homeownership**

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**Developing Effective Subsidy Mechanisms for
Low-Income Homeownership**

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A paper for the April 1, 2013 Symposium: “Homeownership Built to Last”

Panel 2: Informing Tenure Choices and Improving Financing Choices and Outcomes

Abstract:

Public policies at the federal, state, and local levels have espoused to support homeowners and homeownership for decades. Yet, low-income people continue to face barriers to buying homes, primarily because of a lack of income and net worth. Public policies attempt to subsidize these barriers to homebuying for low-income people through tax policies, grants and other strategies. Current policies are, at best, inefficient and inequitable, and, at worst, ineffective. A more systematic approach would adhere to a set of operating principles including achieving scale, focusing on moving renters to ownership, targeting subsidies to underserved populations, creating incentives for repayment, and maximizing efficiency. Designing homeownership subsidy policies invokes tradeoffs between effectively targeting underserved populations and efficiently using scarce public resources. Alternative approaches may point the way to potential innovations in promoting low-income homeownership.

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1. Introduction

Homeownership has captured the attention of policymakers across the globe in recent years, and this attention has often been negative. Bank failures based on failed home mortgages and a nearly worldwide housing recession have raised difficult questions about the viability of pro-ownership public subsidies. In the U.S., high foreclosure rates have provoked a debate over using limited federal resources to promote home purchases (Beracha and Johnson 2012, Davis 2012, Shlay 2006). Yet, demand for buying a home remains strong, even among households most exposed to the negative outcomes of failed homeownership (Drew and Herbert 2012). The lure of owning a home remains part of the social and economic fabric of families and communities (Hui, Yu and Ho 2009). In the U.S. there is a vigorous debate about the optimal role of the public sector in subsidizing homebuying. Policy discussions often include the role of homebuying in stimulating the economy, or the role of mortgages in the financial sector. But a common theme is the concern about how to best aid low-income first-time homebuyers.

To be sure, there are widely discussed rationales for public sector support for homeownership. Economists argue that public sector interventions are justified when the private market fails to achieve an efficient outcome. Inefficiencies may arise in the home buying market in several ways. If homeownership produced positive externalities for surrounding communities, then too few renters would become homeowners than would be optimal for society in the absence of incentives from the public sector. Essentially, the marginal social benefits of higher homeownership rates are greater than the marginal private benefits of an individual buying a home. Tax deductions and credits, grants, and other subsidies reduce the “price” of ownership (the private marginal cost), which moves the quantity of owners closer to the socially optimal level. More owners may lead to improved overall social welfare. Yet, the evidence of these positive externalities is mixed. Recent studies have shown that positive social benefits of owner-occupied homes are more likely due to who buys a home and when, rather than to the tenure of ownership itself (Engelhardt, et al. 2010, Holupka and Newman 2012). On the other hand, owning a property does generate incentives to invest in one’s home and neighborhood. Research seems to support the idea that homeowners work to preserve the value of their property through various mechanisms, including increased civic engagement (Glaeser 2011). Overall, evidence of the positive externalities of greater homeownership is weakly optimistic. Assuming that at least modest positive externalities do exist, making modest supports for homebuying and owning available to all households, regardless of income, may be justified.

Subsidizing homeownership specifically for lower-income buyers stems from additional rationales. The policy argument in favor of subsidizing homeownership for these buyers is rooted in the discrepancies in homeownership rates across households by race and income. Much of the gap in ownership rates can be explained by age and other demographic factors besides income and race. Nonetheless, even controlling for other factors, whites still seem to have better chances of owning a home than blacks or Hispanics, and these differences are concentrated among low-income households (Boehm and Schlottmann 2009, Andrews and Sanchez 2011). In fact, the racial gap in ownership rates is much lower at higher income levels. Long-term statistical trends aside, the notion that all families should have a chance to own a home if they want to is a commonly held ideal (Bostic and Lee 2009, Cramer 2009). Historical failures in real estate and financial markets may have prevented targeted groups from participating in the private benefits of homeownership in the past, and still persist across generations today (Boehm and Schlottmann 2009). To the extent that owned housing may be more likely to be located in places with quality school districts and other services that provide positive environments for families and children, supporting low-income homeownership may enhance inter-generational social and economic attainment.

Going beyond perceptions of social inequality, ownership may also facilitate access to private wealth for lower-income households, wealth that they likely do not accrue in other ways. Historically, home equity is the primary store of non-pension wealth for low-income families (Temkin, Theodos and Price 2010). Home equity accrues over decades of ownership due to the paydown of principal, a form of forced savings, and from any house price appreciation. Price appreciation is, of course, volatile, but over time homeowners often realize some gains in value in real terms (adjusting for inflation) (Kennickell 2012). However, buying a home is not a sure path to building wealth since the length of ownership, loan terms and risks of default or foreclosure can all turn an investment with a positive expected net value into a negative proposition (Galster and Santiago 2008). For owners who make it to retirement and pay off their mortgage, an owned home can provide security in old age, an asset that at least produces shelter. Equity in the home might be tapped for consumption via a home equity mortgage or reverse mortgage, or simply from deferred maintenance and depreciation (Herbert and Belsky 2008). To the extent that public subsidies succeed in expanding low-income homeownership, financially vulnerable families stand to gain from the wealth-enhancing benefits of ownership, again subject to the caveats concerning length of ownership, loan terms and default risk.

Despite the arguments supporting public subsidies to facilitate homeownership among the general population and low-income households more specifically, it is crucial to remember that

homeownership can also entail costs to society. Ownership in the U.S. is closely tied to low-density, energy-intensive single family housing, which may be less efficient than denser designs (Glaeser 2011). Moreover, there are a number of issues related to people who buy homes and then fail to maintain them physically or financially. Lenders face unique information failures when underwriting mortgage loans, especially for low-income first-time buyers who have little prior homebuying experience and minimal track records in financial markets. The mortgage lender cannot observe the borrower's true commitment to the home and ability to make timely mortgage payments. In extreme scenarios, homeowners default on their home mortgage loans and impose significant costs on neighborhoods and government (Haughwout, Peach and Tracy 2010). Ownership also limits mobility such that households in owned homes may not be able to pursue higher income jobs in other areas or re-locate when local labor markets soften (Andrews and Sanchez 2011). These and other potential downsides must be taken into account when balancing the marginal social benefits and costs of ownership, and thereby deciding on subsidies.

Although evidence on the benefits of buying a home is mixed and there are real downsides to homeownership that were evident in the recent housing crisis, political support for producing, financing, selling and maintaining owner-occupied homes is strong (Basolo 2007, Lerman, Steuerle and Zhang 2012). To the extent that the aspirational dream of buying a home remains a symbol of social mobility and economic achievement, the general public also continues to support homeownership (Bratt 2008, Drew 2012). Pragmatically, existing homeowners, entities in the real estate industry, and a host of other constituencies are reluctant to let go of existing public subsidies.

Nevertheless, the political discourse is often dominated by calls for reducing government spending and reforming income tax laws. The deductibility of mortgage interest has been at the center of discussions in recent years, with calls to change or eliminate this longstanding public policy. In this context, the rationale, form, and functions of subsidies for homebuying and homeownership need to be critically considered. Policymakers face the task of developing programs and policies that best use public resources based on the overarching public goals involved. This chapter attempts to outline a set of potential criteria to evaluate policy options to promote low-income homeownership, taking into account the inherent tradeoffs involved.²

² The definition of "low-income" varies. The annual low-income threshold for a family of three including one minor child in FY 2010 was \$18,310 as defined by the U.S. Department of Health & Human Services, and \$14,787 as defined by the U.S. Census Bureau's poverty threshold. The U.S. Department of Housing and Urban Development uses a different formula and allows the definition to vary by local housing costs. The 50 percent of area median

2. Using Subsidies to Lower the Costs of Buying a Home

Policy options for promoting homeownership can be sorted into three broad categories: subsidies, credit enhancements and regulatory actions (Collins 2007). This paper is focused on the first, explicit subsidies. Subsidies are one of the primary mechanisms that government uses to incentivize first-time homebuyers. The second category, credit enhancement, has been a heated issue in the aftermath of the housing crisis of the late 2000s. Credit enhancements, which involve additional guarantees, insurance, or collateral, increase access to capital used to finance a home. In some cases, enhancements lower the costs of borrowing and might be viewed as a subsidy to buyers. The rise and fall of Government Sponsored Enterprises Fannie Mae and Freddie Mac offer a cautionary tale in how credit protections can distort lender and financial institution practices in ways that may not be ideal from a public resources perspective. Nevertheless, the incremental effect of credit enhancements for prospective buyers tends to be small, particularly in equilibrium (Jaffee and Quigley 2009). The third category, regulations related to credit access, housing standards, zoning, and limits on construction, play a key role in making mortgages available and determining where and if homes suitable for purchase are developed. Mortgage market regulations are administered by a collection of independent federal agencies and historically do not involve explicit tax expenditures or appropriations. Zoning and building rules are administered at a local level, and the effects vary significantly depending on local housing market conditions (Glaeser 2011). This third category of policies involves far more than ownership preferences and includes land use, environmental stewardship, and community planning. Although both credit enhancements and regulations affect homeownership generally, they are not the focus of this paper.

Subsidies can essentially be aimed at one of three targets: (1) lowering monthly payments, (2) lowering the initial purchase price, or (3) providing downpayment assistance. Monthly payments for a home include paying the mortgage principal, interest, property taxes, and maintenance costs. The primary avenue for subsidizing monthly payments is an interest rate subsidy, which reduces the cost of borrowing. This can be achieved directly through subsidized loans, or more broadly through the tax code. That is, the government can either subsidize a lower interest rate on a borrower's mortgage directly, or allow borrowers to deduct mortgage interest from their income taxes, lowering their tax burden and indirectly subsidizing mortgage payments. Payments are usually measured relative to income, with a ratio of monthly mortgage payment to monthly gross income commonly used (gross

definition means that "low-income" varies significantly by geography. For example, in Abilene, TX low-income was defined as less than \$23,300, and in Marin County, CA it was \$48,400.

income is income before taxes and withholding for benefits; net or “take home” income is generally 25-30 percent lower). This “payment to income” (PTI) ratio is one measure, with levels around 0.30 and above considered less affordable and increasing the risk of foreclosure. As a higher percentage of income goes to housing payments, unexpected non-housing expenses or temporary drops in income reduce the borrower’s ability to make mortgage payments, potentially leading to default. Some countries subsidize monthly housing payments for targeted homeowners more directly, rather than through interest rates or the tax code (Atterhog and Song 2009). The closest U.S. example to a direct payment subsidy is the use of rental vouchers for homeownership, but this program operates on a very small scale (Olsen 2007).

Subsidies for the purchase price of a home are applied at or before the time a new buyer purchases a home. The subsidy may reduce the purchase price below market rates, or subsidize construction costs that could not be recouped from the sales price. This form of subsidy can reduce the downpayment and mortgage required, thereby lowering monthly payments. This approach raises the possibility that the buyer will resell the home, capture any below-market subsidy, and retain the surplus for him or herself. In addition, purchase subsidies generally represent large one-time lump sum transfers, which are perceived as costly on a per homebuyer basis by policymakers (of course, the present value of a 30 year payment subsidy may also be large but typically is not perceived as being of the same scale). Purchase subsidies are relatively rare and rationed to either specific categories of buyers, or to specific geographic areas. This distinction—targeting subsidies to specific categories of borrowers or to specific geographic areas—is illustrative of the two very different goals associated with purchase subsidies.

One goal of purchase subsidies applied to a specific buyer is to provide financial resources related to the public or private benefits of that household owning a home. The second goal is less focused on the household and more on the neighborhood, with the home purchase viewed as a signal to real estate markets that a particular area is worthy of further investments. Geographically-targeted subsidies may also be designed to stimulate the local economy by employing building tradesmen and suppliers to develop a property into a salable home. However, below market-rate subsidies for purchasing a home must be a scarce resource since widely available subsidies will simply be absorbed into transaction prices. The homebuyer tax credit of 2008-2010 in the U.S. is illustrative. To the extent that a real estate market can anticipate buyers entering the market using purchase subsidies, housing prices will be bid upwards until the last dollar of subsidy is absorbed by an additional dollar of asking price. Some 400,000 first-time buyers in the 2008-2010 time period claimed an average tax credit of

\$7,250 (Government Accountability Office 2010). The credit was primarily designed to stimulate the housing market and the economy more generally (Kocieniewski 2010). The credit was widely available and led to a temporary increase in sales prices rather than a net tangible benefit for first-time buyers, regardless of income level (Goodwin 2011, Brogaard and Roshak 2011).

The last category of subsidy for homebuying is downpayment support. Downpayment support relates to both payment and price assistance, but might be more accurately described as financing assistance. Downpayments perform multiple functions in real estate financing. First, the behaviors that potential borrowers must develop to save a 10 or 20 percent downpayment are consistent with the skills and behaviors related to managing home mortgage payments, such as budgeting and managing cash flow. Second, lenders can face significant information asymmetries related to a prospective borrower's likelihood of default. Formalized downpayment savings plans potentially provide lenders several years of observable data on a household's financial management habits, which both reduces uncertainty and facilitates efficient loan underwriting (Atterhog and Song 2009, Ergungor 2010). The amassing of savings for a downpayment is a signal to a lender that the borrower is likely to be able to manage mortgage debt service obligations. Finally, downpayments are most critical in the case of a downturn in property values. The late 2000s illustrated that the combination of little homeowner equity combined with a decline in home values can leave large numbers of homeowners "underwater," or owing a mortgage that exceeds the value of the home. While being underwater does not automatically trigger defaults, the risks of foreclosure are elevated when a borrower has an income decrease or other shock and has negative equity. A 20 percent downpayment provides a cushion in the case of a drop in prices and can reduce the probability of default. Thus, one potential benefit of downpayment subsidies is a reduction in payment defaults due to the added equity the borrower has in the home (Ergungor 2010).

The U.S. Census Bureau has periodically used the Survey of Income and Program Participation (SIPP) to estimate the potential of income and downpayment subsidies to increase the share of renters who could afford to buy a home. The last report, using 2004 SIPP data, shows that only 2 percent of renters were hampered from buying a home *only* by a lack of income, while a lack of savings for a downpayment was the *only* barrier for 26%. A \$5,000 downpayment subsidy (in 2004) would have raised the ability to buy a home among renters by 10 percentage points (Savage 2009). While resting on a number of assumptions and outdated data, these estimates are consistent with other analyses showing that first-time buyers' primary barrier to the purchase of a home is a lack of liquid savings for downpayment and closing costs (for example, see (Listokin, et al. 2001)

Downpayment subsidies can be structured in a number of different ways, including grants and loans. Loans ideally result in the repayment of capital that is then re-used as a downpayment loan for another borrower. These loans can be amortizing, but most often are designed as “silent” junior liens due at resale or refinance. Because these loans tend to be small, must be monitored over many years, and lose value with inflation, the costs of administering these loans is high relative to the loan amount. Additionally, subsidies in the form of junior liens can constrain owners from taking out additional loans. Instead of loans, some assistance programs use downpayment grants, which are administratively efficient but strictly one-time in nature. Without monitoring, grants may also encourage borrowers to take out home equity loans or lines of credit after the home purchase in order to tap that equity, eroding the value of downpayment subsidies in terms of reduced default risk.

Recent developments will likely result in changes to existing subsidy policies. Under the 2010 Dodd-Frank financial reforms (The Wall Street Reform and Consumer Protection Act), the ratio of total monthly debt (including the mortgage payment) to gross income became a key indicator of the quality of mortgage loans. Under Dodd-Frank, “qualified mortgages” (QM) are less likely to face regulatory scrutiny and less likely to be challenged in court. The total debt to income ratio (DTI) is only binding for borrowers with large mortgage payments relative to income, and/or borrowers with large amounts of other debt, such as student, car or consumer loans. Under regulations issued by the Consumer Financial Protection Bureau (CFPB), potential homebuyers who seek a loan with DTI levels of greater than 0.43 have few options for financing in the traditional mortgage market. This may create an added dimension of public subsidies not just for reducing monthly mortgage debt obligations through payment subsidies, but perhaps subsidies for paying down non-housing debts to enable potential owners to qualify for a mortgage. These rules add further complexity to the use of public subsidies for homeownership going forward.³

Whether used for payment support, purchase price, or downpayments, subsidies for homeownership can be further divided into two subcategories: those directly appropriated and those provided through the tax code. Appropriated subsidies from the federal government are direct grants, must go through the process of annual budget submissions by the White House, and must then be approved in budget bills in the House and Senate. Tax subsidies are classified as either tax deductions or tax credits. Tax deductions are claimed by taxpayers on their tax returns to reduce taxable income and

³ Although discussions are ongoing at the time of this writing, a stricter qualified residential mortgage (QRM) rule promulgated jointly by six federal financial regulators defines the standard for loans allowed to be sold in the secondary market without risk-retention. Current QRM standards include 20 percent downpayments and a 36 percent DTI.

therefore reduce total tax liabilities. Because of the nation's progressive tax rate structure, reducing \$1 of taxable income in a 33 percent marginal tax bracket is worth \$0.33, while a \$1 deduction of income in a 15 percent marginal bracket is worth only \$0.15. As a result, taxpayers with more income in the highest brackets benefit more from tax deductions relative to taxpayers in lower-income tax brackets. Tax credits actually offset the amount of total tax due, rather than just reducing the amount of income subject to tax. Since tax credits are of little value to taxpayers with low tax bills, credits are sometimes sold to corporations or individuals with larger tax liabilities. In some cases, credits are refundable, meaning that a taxpayer with small or no taxes due can receive a tax refund based on the credit.

3. Strategies for Subsidizing Low-Income Homeownership

Turning from the general approaches to specific subsidies, the next decision for policymakers is how to implement programs targeted to lower-income first-time buyers. The intent of a subsidy is to change behavior: to incentivize low-income renters to buy their first home, and then ideally to sustain ownership over a long enough period to engender the potential positive externalities of homeownership. Focusing on low-income first-time buyers, barriers to ownership tend to relate to having both a low income and low levels of net worth (savings less debts). Income subsidies are obviously one general mechanism to aid low-income people to buy homes, as well as to increase consumption of all other goods, but are not aimed at helping renters in general purchase homes. In the U.S., there are currently four examples of purported supports for low-income homeownership, each of which is examined briefly below.

Mortgage Interest Deduction

The mortgage interest deduction is a subsidy for homeownership delivered through the tax code. It is by far the largest support for owning a home in the U.S. and applies to all homeowners, not just those with low incomes. Mortgage borrowers may deduct mortgage interest from taxable income when calculating federal (and by and large state) income tax. This deduction can reduce tax liabilities for homebuyers, and thus increase income available for monthly housing payments. The mortgage interest deduction is the second largest tax expenditure for individuals in the federal budget, after the exemption for contributions to pension funds. However, the deduction is primarily an incentive to borrow using more mortgage debt rather than an incentive for lower-income renters to become owners. Most lower-income taxpayers take the standard deduction on their federal income taxes and do not claim the mortgage interest deduction. Only 10 percent of tax filers with incomes under the median income itemize. (Davis 2012, Government Accountability Office 2010). The progressive nature of federal

income tax rates results in lower-income owners receiving a smaller deduction as a percentage of income than more affluent buyers even if they itemize their deductions. Recent studies suggest that the mortgage interest deduction is largely capitalized into house prices (depending on the elasticity of local housing markets) and in reality is less of a support of homeownership than many policymakers assume (Glaeser 2011, Davis 2012, Bourassa, et al. 2012).

Mortgage Payment Subsidies

One of the most well-known mechanisms to reduce borrowing costs for first-time, lower-income home buyers is single-family housing bonds, known as mortgage revenue bonds (MRBs). MRBs are sold to investors in order to finance below-market interest rate mortgages. Investors are willing to purchase these bonds at below-market interest rates because the income from MRBs is tax-free. State housing finance agencies are allocated a per-capita amount of tax-exempt housing bond authority each year. By law, MRB-backed loans are limited to first-time homebuyers who earn no more than the median income in their area. If a borrower's income rises above eligible levels, up to one-half of any profit from the sale of the financed home may be recaptured for up to nine years (although in practice this rarely occurs). MRBs are administered by designated state agencies that issue the bonds and monitor loans. Because of the mechanics of issuing the bonds and the relative value of tax exempt interest, the value of MRBs to first-time buyers fluctuates over time. In general, the resulting payment subsidy is relatively low, typically less than one percentage point below prevailing market rates (Ergungor 2010, Durning 1987). The housing market recession and historically low current interest rates across the market interest rate yield curve mean that MRB loans may offer no subsidy, but simply a streamlined access to mortgages for low-income homebuyers with little payment support (Moulton 2010, Moulton and Quercia 2013). MRB loans, for example, are exempt from the CFPB's qualified mortgage regulation restricting debt-to-income ratios. Assuming a return to a more historically average yield curve, MRBs at least have the potential to also offer payment subsidies. The net present value of a 1 percentage point reduction in interest rate, discounted at inflation (CPI) for a \$160,000 mortgage is approximately \$7,000 over ten years. A similar though smaller-scale financing mechanism is the U.S. Department of Agriculture (USDA) Direct 502 Loan program. Instead of relying on tax advantaged borrowing, 502 loans are made and held by public agencies with the goal of promoting very low income homebuyers in rural areas. The interest rates on these loans can be as low as 1 percent, depending on income.

Downpayment Grants

The Community Development Block Grant (CDBG), HOME Investment Partnerships (HOME), and Federal Home Loan Banks (FHLB) Affordable Housing Program (AHP) are all sources of funds used by local governments or nonprofits to make direct grants to first-time homebuyers for downpayments. Downpayment funds may not be issued as grants but can be provided as an interest-free loan due at the sale of the home. These revolving loan funds allow more households to receive assistance as downpayment loans are repaid. Downpayment grants and loans are highly-targeted methods of helping specific populations become first-time homebuyers. Unfortunately, each grant or loan could require \$16,000 or more (assuming a \$160,000 home price and 10 percent downpayment), resulting in far more buyers who qualify than can receive support given limits on scarce grants dollars. In effect, this assistance becomes a lottery serving a small share of eligible borrowers. Downpayment savings subsidies can, of course, be smaller and still be effective—even assistance in the range of \$1,000 can be enough to help a renter qualify to buy a home in some markets (Herbert and Tsen 2007). For example, the American Dream Down Payment Initiative, a demonstration project using HOME funds for downpayments from 2004 to 2008, provided an average of \$5,000 per homebuyer (U.S. Department of Housing and Urban Development 2012).

Sales Price / Development Subsidies

Building a home, or converting a structure used for another purpose into a dwelling suitable for homeownership, entails significant costs. Acquiring land for development, or an existing unit for renovation, is often the most significant cost, but the fixed costs of permits, approvals, and other code requirements are also often high. In some locations, the cost of building or renovating affordable homes exceeds prevailing market values. Both the HOME and CDBG programs are used to help fund the development or re-development of affordable units suitable for ownership. Local governments and nonprofits use these federal subsidies to create a small number of targeted housing units suitable for affordable homeownership for low-income families. Ideally, these subsidies are focused on neighborhoods where the costs of development exceed market values and no private construction would occur in the absence of the subsidies. Although units are typically sold to low-income buyers, the primary intent of these subsidies is to spur real estate markets, with the support of first-time homebuyers as a secondary consideration.

Impacts on Affordability

Figure 1 illustrates how monthly payment, downpayment, and price subsidies each can be employed for a buyer of a \$160,000 home with an income of \$45,000 and, as the base case in Column A, a 10 percent downpayment, and a 30 year fixed rate mortgage. The buyer has \$11,250 in annual non-mortgage debt obligations, or \$938 per month. This is relatively typical for a highly leveraged household that has, for example, student loans, an automobile loan and credit card debt (Dyanan 2012). Given the CFPB's debt to income (DTI) qualified mortgage regulation, non-mortgage debt levels are important to include in such illustrations. In Column A, using a 4.5 percent mortgage interest rate, the DTI is 0.44 and would not meet the qualified mortgage (QM) standard. Using an MRB loan with an interest rate of 3.5 percent reduces the monthly payment by \$83, or about an 11 percent decrease over the base case. This reduces the DTI to 0.42, which would meet the QM standard. Although not a deep subsidy, in this case the MRB may open up ownership to a renter without first requiring the renter to pay down other debts.

Column B shows the same buyer, but now with a downpayment of 20 percent overall, including downpayment assistance (DPA). The additional 10 percentage point downpayment lowers the principal balance and reduces the monthly payment by \$81, pushing the DTI to 0.42. In this case, the DPA subsidy achieved similar effects on affordability as the MRB payment subsidy. Combining the DPA with an MRB loan, which is common, reduces the monthly payment by \$155 and the DTI down to 0.40. Monthly mortgage payment burdens in this situation are lowered by one-fifth from the base case. Note, however, that saving the downpayment and closing costs is a substantial endeavor for the borrower. A 10 percent downpayment and 2 percent closing cost requirement translate to \$19,200 in savings required for either case (in column B the borrower would receive \$16,000 in downpayment subsidy). For a household earning \$45,000 per year, saving 5 percent of gross income (not take home income), invested at a 5 percent annual rate of return, would take 4.5 years to accumulate. Coming up with 20 percent downpayment without the downpayment subsidy would delay home purchase by an additional 4.5 years.⁴

4. A Framework for Evaluation

If a policy goal is to expand ownership among low-income households, a well-designed subsidy policy focused on low-income first-time buyers specifically might include a number of characteristics.

⁴ Estimates based on real terms—over time income and home values will inflate in nominal terms.

Figure 2 outlines eight factors that policymakers ought to consider when designing or evaluating new policies to subsidize low-income homeownership.

The first factor is scalability. A number of existing federal programs have small appropriations, have limited administrative capacity, and suffer from a lack of awareness. Programs that promote homeownership need to be large enough to benefit low-income renters so they incorporate the subsidy into their expectations related to the costs of buying a home. An arbitrary benchmark might be serving at least 10 percent of the target market. For example, in a year with 120,000 first-time buyers with incomes at or below the HUD 50 percent AMI (area median income) cutoff, the program ought to serve at least 12,000 first-time buyers. Market share values less than 10 percent might still influence renters to consider buying a home, but at some level programs are likely to become too small and unknown to effectively influence behavior.

The second factor labeled in Figure 2, marginal effect, refers to the policy's effectiveness in encouraging renters who would not typically purchase a home in the absence of the program to buy a home. . Ideally, a program converts a renter who would never buy a home into a homeowner, but the program might also encourage people who would have bought a home within a few years regardless (e.g. perhaps when their income is higher) simply to purchase a home now.⁵ Potential negative outcomes include incentivizing consumers to purchase bigger homes than they would otherwise demand, or encouraging them to take out larger mortgages. These marginal effects—that are not related to ownership but rather to the intensity of ownership among owners—are not as directly related to expanding the number of owners from targeted income groups. It should be noted that policies focusing on savings for downpayments and closing costs may offer the greatest potential for converting the marginal renter into a homeowner, although at significant cost. Because it can take years to accumulate savings, policies may accelerate owning in the lifecycle for some households, while for other households owning a home may have never been an alternative without the policy.

The third factor is targeting,. The program needs to be designed, tested, marketed, and operated with an explicit restriction to borrowers who fall below particular income thresholds relative to area median incomes. Programs might also serve a wider demographic but offer stronger incentives for lower-income buyers. Without targeting, it is difficult to justify new homeownership policies as being directed to support low-income homeownership.

A fourth, and critical, factor is the efficiency of administration. Too often, subsidy programs trigger reams of regulatory restrictions that limit access and absorb a significant portion of resources for

⁵ Generally, a first-time buyer is defined as someone who has not owned a home in the last 3 years.

overhead rather than activities with a direct impact on communities. Administration includes outreach, intake/application, disbursement of funds, and monitoring. Since homebuyers may remain in a subsidized home for a decade or more, the present value of ongoing administrative costs can be significant.

A fifth factor is subjecting the subsidy to some form of recapture. Recapture can take two general forms. One is to penalize buyers who violate the restrictions or terms of the subsidy, such as renting out a purchased home or earning income that exceeds the levels directed in the policy. The other form is some mechanism to boost the scale and sustainability of programs by making their resources recyclable to the extent possible, so that a single subsidy can be reused for subsequent first-time homebuyers. For example, a buyer might pay back a downpayment subsidy, or the purchase subsidy may be retained to lower the sales price for the next owner of a unit. Both of these approaches can be administratively costly if they entail active monitoring and enforcement, so recapture needs to be balanced against administrative efficiency.

A sixth factor to consider is a subsidy program's neighborhood externalities. A subsidy focused on a specific geographic area might serve as a way to generate attention for an undervalued part of the housing market. Attractive design and amenities might generate further private investment that begins to revitalize troubled neighborhoods. However, to the extent homeownership programs relegate low-income homebuyers to disinvested areas that offer fewer amenities or access to opportunities, the neighborhood benefits of owning a home may be undermined.

The seventh factor is the subsidy's impact on loan default risk. At one extreme, a subsidy could reduce information asymmetry for lender underwriting, lower exposure to negative house price changes, and provide buyers with a more secure position in case of a negative financial shock. At the other extreme, a subsidy could reduce buyers' financial stakes in their homes and leave them with fewer incentives to maintain their properties or keep up with mortgage payments. The ideal program would reduce the probability of default, all else equal.

The eighth and last factor is that the policy should not impair the ability of the homebuyer to sell or move in response to employment opportunities or household disruptions. Owning a home ties a household to a specific labor market. This can become a significant disadvantage, especially for workers with lower incomes and less human capital, as households try to respond to changes in the local labor market.

Not included in the eight criteria are a number of additional issues policymakers considering approaches to promoting low-income homeownership may also want to consider. One issue is whether

“wealth creation” is an explicit goal. One of the benefits of owning over renting is the accumulation of home equity as principal is repaid (and perhaps home values increase). Policies might deliberately enhance or reduce the potential for buyers to build wealth in the form of equity in the property. Another issue is whether the subsidy should be neutral related to preferences for a particular structure type. In some regions, detached single family homes are the predominant structure type, but other areas have a more diverse housing stock including high-density multi-family buildings. Low-density detached homes can contribute to sprawl, traffic congestion, and energy use, all of which may not be socially optimal. Programs might award incentives for the purchase of certain structure types. Finally, offering transfers of wealth or income to reward ownership leaves comparable renters who prefer not to own relatively poorer. The implicit tradeoff of homebuyer subsidies is that some households for whom renting was optimal are in fact pushed into owning a home.

Together these factors provide a useful lens for evaluating policies designed to promote low-income homeownership. Using these criteria, current policies along with potential policy alternatives for low-income homeownership can be evaluated.

5. Applying the Framework

Figure 3 illustrates how the eight criteria can be applied to the four existing policies surveyed in the prior section. The first row describes the mortgage interest deduction (MID), and each column corresponds to a factor outlined in

Figure 2. The MID is clearly scalable. In 2010, based on U.S. Internal Revenue Service (IRS) data, more than 37 million taxpayers claimed the deduction (Internal Revenue Service 2012). The MID is generally not found to encourage new homeownership, but rather to expand the intensive margin of owning bigger homes and taking out larger mortgages (Bourassa, et al. 2012). The MID is also not well targeted. IRS data show that most of the benefits of the MID go to higher income households. The administrative costs of the MID are low, since the deduction is simply entered into the tax form (income tax filing entails significant administrative costs; the costs of adding the MID to that process are relatively small). There is no recapture mechanism for the MID, nor are there any enforcement regulations. The MID has little bearing on the risks of default for low-income buyers and presents no restrictions on moving or resale that might impair household mobility. Overall, the only advantages of the MID as a public policy are that it has a large scale and is administratively efficient. The MID has little influence in encouraging homeownership among lower-income households and would not be worthy of support using this framework.

The next row in Figure 3 covers the Mortgage Revenue Bond program (MRB). About 59,127 first-time homebuyers are aided by MRB mortgages in 2010, based on \$2.4 million in bond sales.⁶ This is a reasonably large scale given that about 5 million homes were sold in 2012, of which about 1.9 million (37%) were first-time buyers. Among first-time buyers, about one-third had low incomes, leaving an estimated 550,000 first-time low-income homebuyers.⁷ Based on this estimate, MRBs support about 1 in 10 of households in the targeted demographic. The MRB subsidy is shallow, however, and it seems unlikely that the monthly payment reduction of about 1 percentage point (100 basis points) is enough to move renters into owning, relative to borrowing more or buying more housing. Nonetheless, no rigorous studies have evaluated the causal effects of MRBs on owning a home (studies of FHA lending programs, which are similar by some measures, are mixed but generally positive). The MRB program is reasonably well targeted. MRB regulations restrict access to borrowers with incomes under the median area income buying homes priced less than 90 percent of the area mean home sale price. In a strong economy with high demand for tax-advantaged bonds, the MRB program can serve a larger number of borrowers with lower overhead costs. In weaker points of the economic cycle, low demand erodes the return on bonds and results in higher administrative costs. This program enforces recapture of a portion of the subsidy for homes sold within nine years of buying the home in the form of a tax imposed on net sales proceeds, but income levels are not monitored after the loan is made. The subsidy is typically not recycled, as the

⁶ National Council of State Housing Agencies (NCSHA) <http://www.ncsha.org/advocacy-issues/housing-bonds> [accessed 01/15/2013]

⁷ National Association of REALTORS <http://www.realtor.org/news-releases> [accessed 01/15/2013]

loan payments are used to fund the bonds—the bonds have lower interest rates than market rates because investors were willing to bid up bond prices to acquire tax-advantages. MRBs may be targeted at lower-priced units and used for combined purchase-home rehabilitation loans. In this sense, MRBs might support neighborhood improvements, but the use of MRBs for these purposes is limited.

The role of MRBs in default risk is likely mixed. Unlike the MID, the subsidy is not simply capitalized into house prices, so homebuyers may experience a real reduction in housing costs. The rate reduction remains relatively small, however, such that payment ratios are not reduced dramatically. Finally, because of the recapture provisions, which decrease over time, MRBs may in fact present at least perceived barriers to mobility for low-income households. In practice, borrowers can usually avoid recapture.⁸ Overall, the MRB has many advantages using this eight-point framework, especially in terms of scalability and targeting. Nonetheless, it is a shallow subsidy, and the extent to which MRB results in higher homeownership rates among low-income households who otherwise would not have owned a home is unclear. The USDA 502 Direct loan program shares many of the features of MRBs, with two exceptions. 502 loans are small in scale, with fewer than 2,000 loans in 2010, and the subsidy can be targeted by income level to provide lower interest rates.

The next category of subsidy in Figure 3 is downpayment assistance (DPA). About 15,000-20,000 homeowners are aided per year across federal downpayment assistance programs (HOME, CDBG, FHLB and USDA), and almost all of whom are first-time, low-income buyers. Estimates vary because in practice DPA is often combined with other programs, including MRB loans. Downpayment assistance usually does not eliminate all borrower contributions (in addition to closing costs), but can be used to write down the mortgage balance to both qualify for lower interest rate loans based on the loan-to-value ratio, as well as reduce the monthly payment. The size of DPA subsidies limits the policy's scale given existing appropriations levels. Even with more resources, the screening and oversight required limit the potential number of borrowers who can be helped annually. Studies are suggestive that a lack of a downpayment is the primary barrier to buying a home for the lion's share of low-income renters. The subsidy can be substantial enough to make ownership possible for households that are otherwise unable to buy a home. The difficulties in acquiring significant savings by low-income renters means that without DPA, ownership would be delayed – potentially indefinitely. DPAs are also well-targeted through the application process to exclusively channel subsidies to means-tested households.

⁸ To owe any recapture: (1) the home must be sold within nine years of purchase, (2) the borrower must earn significantly more income than when he or she bought the home (the equivalent of 5 percent increases annually), and (3) the borrower must sell the home for more than he or she paid for the property initially.

The oversight structure required for these programs also results in elevated administrative costs. These costs are higher still if the DPA is structured as a silent junior lien loan that has to be monitored and recaptured at re-sale. Of course, the benefit of those added costs are that the DPA subsidy can be returned to a pool for use with future buyers.⁹ Like MRBs, DPAs might be used as part of community revitalization strategies, but they are not always used in such a manner. One of the most valuable aspects of the DPA subsidy is the potential to lower default risks (Ergungor 2010). As the amount of equity in a home increases, borrowers' risk of being "underwater" on their mortgages decreases. DPAs do present some barriers to resale, which could restrict mobility, especially if the home has dropped in value and the silent junior lien for the DPA cannot be repaid. It should also be noted that the source of downpayment may matter in terms of loan performance. During the housing boom seller contributions to downpayment represented a way to inflate home sales prices in order to rebate cash to sellers to use for the closing. The act of saving for a downpayment—including practicing behaviors such as planning, budgeting and managing funds—may convey skills that support improved loan performance. Savings programs, such as Individual Development Accounts (IDAs), that support savings over time, as well as sweat equity requirements, may also develop complementary skills that enhance the ability of borrowers to maintain their home and mortgage loan.

The next subsidy covered in Figure 3 is related to the sale price, either as a direct discount or an embedded discount in the home construction or development process. Like DPAs, subsidizing properties to below market values can be costly per homebuyer. This high cost results in a small-scale program, although there are few estimates of the number of new owner-occupied units with final sales prices subsidized by programs such HOME and CDBG. The marginal effect of sales price subsidies may be significant, however, and has the potential to support renters who otherwise would not have bought a home, or would have delayed purchasing a home for a long period (longer than the three-year window considered in the definition for first-time buyers). Price subsidies are usually targeted to low-income first-time buyers, although local strategies may seek to encourage moderate-income families or non first-time buyers into particular areas through subsidies. The administrative costs of providing and monitoring construction subsidies are substantial; the cost of managing the allocation of scarce home price discounts also requires non-trivial costs. The recapture of subsidies varies but may be accomplished with a lien on the home or restrictions on resale. (A related version of recapture is a shared equity model, discussed in the next section.)

⁹ Currently, most DPAs are administered by local nonprofits or state/local government agencies. Servicing these loans could be more efficient with higher scale centralized processing systems.

Neighborhood revitalization is often the primary goal of price subsidies, rather than aiding low-income homeownership. The effects of investing in one property in an area may have the potential to generate positive local market effects (Edmiston 2012, Wyly, et al. 2001). The effects of price subsidies on default are unclear, but if the sales price and mortgage are below market prices, the probability of borrowers owing more than the home is worth in the market decreases. Project-based subsidies can also serve inclusionary purposes to facilitate selected lower income households to have access to higher income neighborhoods, quality schools or transportation hubs. Finally, price subsidies may require minimum periods of ownership and impose penalties upon owners for resale of the home. These may constrain household mobility. Overall, price support subsidies seem to echo the pattern of DPA subsidies: high cost, small scale and well-targeted. Nonetheless, subsidies for purchase price often have an explicit community development aim that may trump any low-income ownership goal.¹⁰

6. Alternatives Approaches

Overall, this brief survey of existing mechanisms above is not encouraging. The largest of the existing subsidy mechanisms, the mortgage interest deduction, does little to promote low-income homeownership. Proposals to reform the MID range from the draconian (complete elimination) to the idealistic (refundable credits available to owners and renters) to the pragmatic (gradually phased in reductions in total deduction value). While the MID has wide scope, there is a danger that this debate can drown out evidence-based analysis of other programs and approaches. This begs the question: What other alternatives exist?

Savings Programs

Policies that subsidize renters to save for a downpayment to buy a home offer an alternative to downpayment assistance. Internationally, savings schemes have been part of the homeownership policy strategies used in countries such as the UK, France, Canada, Singapore, and Australia at various points in time (Munro 2007, Atterhog and Song 2009, Bourassa, Greig and Troy 1995). The design of these programs varies, but in general they support savings over some period prior to the homebuying process. The subsidy may be in the form of a direct payment, tax incentives for the savings, and/or earnings in the downpayment account, and the use of tax-advantaged retirement or pension accounts for the purposes of a downpayment. Beyond the subsidy, this design has other advantages. A structured savings

¹⁰ In fact, promoting low-income people to buy in areas targeted for revitalization may be counterproductive; moderate-income residents may be required to produce a mixed income distribution.

program can help renters overcome behavioral problems such as myopia, procrastination, or a lack of self-control. Pre-commitment to saving could help renters adhere better to a plan to save for a downpayment (Andrews and Sanchez 2011). The design also can be linked to mortgage underwriting. In France, for example, the *Plan Epargne Logement* (PEL) is a program administered by private banks that requires potential owners to save for at least 18 months. The account has minimal interest earnings, but the federal government provides a lump sum subsidy when the borrower takes out a mortgage. The bank has the advantage of observing at least 18 months of savings behavior, which partially overcomes the information asymmetry lenders face in underwriting first-time buyers (Atterhog and Song 2009).

In the U.S., the most widespread mechanisms that might be cast as a downpayment savings program are individual development accounts (IDAs). IDAs are special matched savings accounts restricted for uses such as education, starting a business, and buying a home. In practice, downpayments are one of the most common uses of IDAs (Mills, Gale, et al. 2008). A Department of Health and Human Services program called Assets for Independence often matches IDA funds. Match rates vary by program but can be generous, including one-to-one matches or more in some cases. Most programs are operated by community-based organizations at a relatively low scale. Despite the small scale, programs may provide opportunities for education, advice, and support for positive financial behaviors which lead to more sustainable homeownership (McKernan, et al. 2011).

A very different approach to subsidizing savings is the use of Low Income Housing Tax Credit (LIHTC) financed rental housing to structure a lease purchase for current renters. The program requires renters to remain in a qualified unit, building up “equity credits” each month that can be used to buy the unit when the tax credit period expires (Immergluck and Schaeffing 2010). Though these credits are not liquid and can only be used to save for home purchase, they do represent a form of forced savings. The model only works, however, when a nonprofit developer is willing to build the costs of these incentives into the rental structure.

The previously described is a heterogeneous set of policy alternatives, but all work with renters to build up savings over a period of a year or more. Turning to Figure 1, the merits of these savings approaches can be analyzed based on the eight policy criteria. Scalability seems possible, although both IDAs and lease-purchase arrangements are relatively small scale in the U.S. A plan administered by banks, such as the PEL in France, can certainly take on a larger scale. Regarding the marginal effect, it seems likely that savings programs benefit renters who need a structure to accumulate the savings required for mortgage underwriting. These programs are also easily targeted by income level. Administrative costs of these programs are all related to enrollment and monitoring during the savings

period; once the home is purchased and funds are dispersed, the administrative burden is largely terminated. The oversight of IDA savings does require an infrastructure. Currently, community-based agencies provide this infrastructure, and administrative costs per dollar of subsidy can be high (Mills, Patterson, et al. 2004). Savings programs have no way of guarding against homeowners selling the home to pocket the subsidy, nor of recapturing the subsidy for future use. There is also no revitalization component to savings strategies. It seems likely that accumulating savings will facilitate lower mortgage default risks. Having more equity and lower loan-to-value ratios help in this regard, and taking part in a structured savings plan that is transparent for underwriting the loan may also contribute to lower default rates. Finally, because savings programs are concentrated pre-purchase, there are no additional restrictions to selling or moving to seek other opportunities. Overall, savings policies appear to function much like other downpayment subsidies, the difference being the longer-term structured savings contributions from the potential homebuyer. This reduces the amount of subsidy required and provides information for lenders that might help screen borrowers and reduce defaults. The period of savings provides a proving ground for potential borrowers to gain skills and knowledge, as well as practice behaviors that are useful in managing a mortgage and home expenses.

Limited or Shared Equity Models

There are a variety of partial or shared equity forms of housing, including land trusts, cooperatives, and programs where residents trade off some portion of their equity in property for affordability or security of tenure (Lubell 2013). Community Land Trusts (CLT), for example, are a very different form of homeownership than the alternatives presented in this paper thus far. Private households purchase homes and then have ground lease contracts that establish a conditional property right for the structure located on the CLT's land. Because it controls the terms of the ground lease, the CLT can restrict the purchase of homes to only low-income buyers and determine the sales price of the structure. The home is sold at a below-market price, creating a subsidy. When the homeowner re-sells the house, he or she sells it to the CLT for a pre-determined price based on a formula that accounts for the buyer's paid-in equity (downpayment, principal, improvements) and a portion of any appreciation in the value of the underlying land. In the U.S., there are 258 CLTs with about 9,000 total homes (Federal Reserve Bank of Richmond 2012). While small in scale, the performance of mortgages on CLT properties has been positive (Temkin, Theodos and Price 2010). The structure of CLTs, their targeted income level, and the resale formulas vary, but all are generally designed to help low-income families buy a home and then retain any subsidy so that subsequent borrowers can also benefit from an affordable purchase

price. The tradeoff is that buyers may not benefit as much from strong home price appreciation, which raises an important discussion of whether homeownership should be encouraged as a speculative investment (Munro 2007).

An application of the Figure 2 framework reveals several unique advantages of the CLT model. Although the CLT system in the U.S. is small, the basic model could be administered much like asset management firms govern rental housing. Barriers to scale include legal limitations and ambiguities related to the structure of the ground lease and financing. Often, CLTs are developed based on new construction or large-scale improvements of multiple existing structures located in a finite geographic area. This requires significant organizational capacity and often public subsidies for administrative costs, as well as subsidies for acquisition and construction costs (Davis 2006, Whitehead 2010). All of these factors limit scale in the U.S. The extent of the marginal effect of a CLT model depends entirely on the level of subsidy passed to each successive buyer. The price of ownership may be lower due to the separation of land and structure, but the ground lease effectively reflects the value of the stream of services that the piece of land provides to the homeowner. That is, the legal arrangement does not inherently lower the financial price of the home or enhance ownership opportunities. If the CLT is structured with subsidies that are sustainable and that lower the price of ownership relative to the housing attributes provided, then the CLT may in fact extend homeownership to households that otherwise would not have become owners.

The CLT model is easily targeted to low-income buyers based on means tests. In addition, the CLT can clearly recapture subsidies; in fact, this is a hallmark of the model. CLT models could re-certify income and potentially re-negotiate ground leases in cases where a homeowner's income increases dramatically; in practice, this is unlikely. The upfront and ongoing administrative costs of owning land, managing ground leases, and enforcing resale provisions are high. As such, this is among the more costly alternatives (as with downpayment loans, the costs of recycling the subsidy can call into question the benefits of recapturing relative to a one-time subsidy). Yet, this is a model that has potential to revitalize a neighborhood or community since it involves a number of homes within a local area. The CLT model also is likely to be associated with lower default risks (Jacobus and Abromowitz 2009, Temkin, Theodos and Price 2010). Mobility is not restricted per se, but owners who sell shares in a CLT may be hard pressed to find another CLT for a subsequent purchase. Because the CLT is the buyer, a CLT model may actually offer greater liquidity to homeowners needing to sell. If the unit is truly discounted relative to the market, resale will be rapid as demand surely will be strong. Overall, the CLT model has several attractive aspects from a policy perspective, including the recapture of development/purchase price

subsidies. The form of CLT, the design of the resale formula, and the administration structure vary and largely determine the efficacy of this form of subsidizing low-income homeownership. Like other models, reaching more buyers will require changes in law and public administration.

There are several other approaches similar to the CLT model. One is a limited equity cooperative housing model. Like other housing cooperatives, residents own 'shares' in a cooperative housing corporation. These shares provide the right to a housing unit (typically in a multifamily building) and joint management control. In a limited equity co-op, owners can resell their unit shares. The price is not determined by the market but instead by a formula similar to that of the CLT model, which returns paid-in equity and modest market appreciation. The subsidy typically applies when the coop is initially developed, or when an existing property is re-capitalized with public funds. The limited equity model is attractive from a policy perspective because a large one-time development subsidy can be retained in the unit for subsequent buyers. The administrative model is different from the CLT, but the issues of scale, administrative costs and other factors in Figure 1 remain.

The deed-restricted home is another related approach. Typically designed in high demand housing markets, there may not be a direct public subsidy as much as a requirement that in order for a private developer to obtain a construction permit, he or she must include owner-occupied units that are affordable to lower-income families. The deed or covenant on the property restricts resale to another income-eligible homebuyer using a formula for the sale price. Covenants typically provide that a unit must maintain its resale restriction for at least 30 years. While this approach has potential in some markets with active new construction, like other shared limited equity models, it is small in scale and requires ongoing administrative oversight.

There are several other variations on this theme. Shared ownership/equity models are not uncommon overseas and are used to support low-cost homeownership initiatives aimed at extending homeownership. In the UK, for example, shared ownership programs are structured so that the purchaser buys a proportion of the property with a traditional mortgage (for example 80 percent), while the other portion (20 percent) is owned by a local public or nonprofit housing agency (called a "social landlord"). The homeowner pays rent to the landlord for the 20 percent share and pays a mortgage for the 80 percent share. Over time, as the owner's resources expand, the owner can buy out the 20 percent share and become the sole owner (Whitehead 2010, Whitehead and Yates 2010). Somewhat similar approaches that use shared equity mortgages instead of ownership shares have been suggested in the U.S. (Caplin, et al. 2007). While not aimed at using public subsidies to support low-income

homeownership, these examples illustrate the innovative alternatives that partial ownership and shared equity models can present.

7. Conclusions

Homeownership provides risks and rewards for households. In some scenarios, extending the private benefits to lower-income families who cannot afford homeownership can enhance overall social welfare due to the potential positive externalities of homeownership. Even if the community benefits are not large, subsidies for low-income homeownership may be warranted out of equity concerns due to the private benefits of owning a home. Access to these benefits underlies public policies that enhance ownership opportunities for low-income families who currently rent and for whom ownership is unlikely without public support. This chapter has focused on the role of public subsidies to promote ownership for low-income, first-time homebuyers. Even once policymakers agree on the need for subsidies, the form of subsidy and design of the specific program can have important effects on the sustainability of homeownership and the efficiency of the use of public funds.

There are three basic forms of subsidies for first-time buyers: (1) payment subsidies to lower the monthly ongoing cost of owning a home; (2) subsidies that lower the initial purchase price of the home; and (3) subsidies that reduce the downpayment required to qualify for a home mortgage. Recent federal regulations have added to the complexity of these alternatives by focusing on maximum total debt payment to income. Although all three subsidies can lower debt burdens, lowering housing and/or other debt service costs may become more important as a means to expand ownership in the future.

Currently, federal subsidies for low-income homeownership employ payment, purchase price, and downpayment subsidies. Each involves significant tradeoffs and deserves scrutiny relative to the goal of promoting low-income ownership. The mortgage interest deduction, for example, offers little support for low-income buyers despite representing a large tax expenditure in the federal budget. Mortgage revenue bonds offer the potential to lower monthly payments for buying a home, but these bonds offer a very shallow subsidy in the current market. Downpayment grants and loans can reduce the size of initial mortgages and reduce default risk, but are more costly to administer. Purchase price/development subsidies can be large in magnitude and have positive effects on local housing markets, but are not capable of serving a large number of first-time low-income homebuyers. Alternative policies related to downpayment savings initiatives and shared or limited equity models are worthy of consideration in light of the shortcomings of existing policies. Variations of these alternative

models are used in limited instances in U.S., and experiences from abroad can be illustrative for the formation of new approaches.

Policymakers can consider these and other policies based on a series of eight criteria: (1) scalability; (2) effectiveness in causing renters to become homeowners rather than subsidizing households who will become homeowners even without the subsidy; (3) targeting low-income individuals; (4) efficient administration; (5) recapturing the subsidy when buyers are no longer owner-occupants or low-income, as well as recycling funds across subsequent buyers; (6) neighborhood impact; (7) lowering default risk; and (8) minimizing restrictions on household mobility. No policy matches the ideal across all criteria, and within and across criteria there are implicit and explicit tradeoffs. Policymakers considering subsidies for promoting low-income homeownership should consider these factors in the design and pilot of new programs.

No policy currently under consideration satisfies every criteria. There are further issues to consider, each of which triggers complicated trade-offs for policy makers. First, it is important to consider how the accumulation of home equity as wealth should be treated as a policy goal. Limiting equity erodes one of the benefits of owning a home but allows subsidy to potentially support more households. Second is how structure type should be treated under any policy. Preferences for multifamily buildings has rarely been incorporated into policies, but at least in some markets could be consistent with community planning goals. Finally, any subsidy for owning a home—regardless if designed as an income or wealth subsidy—raises the budget constraint of homeowners and leaves renters relatively worse off. The ratio of the costs of owning versus renting are shifted to favor owning. While owning is a policy goal, incentives to buy a home may push some low-income households for whom renting was optimal into owning a home. And if subsidies are large enough, housing markets may anticipate certain classes of buyers will use public programs, raising the price of land and homes in equilibrium. Balancing these concerns is challenging.

Despite the housing crisis, policies continue to provide support and incentives for homebuying. These programs are not optimally designed for low-income renters who want to buy a home. Based on a critical review of existing and innovative ways of delivering one-time and ongoing subsidies, policymakers can assess current capacity and infrastructure to focus subsidies on high-impact strategies.

8. Figures

Figure 1

Payment, Downpayment, Purchase Price Subsidy Examples

\$160,000 home, borrower with \$11,500 in consumer debt.

	A (MRB)	B (DPA)
House Sale Price	\$160,000	\$160,000
Income	\$45,000	\$45,000
Other Debt / mo	\$938	\$938
LTV	0.9	0.8
Cash required	\$19,200	\$35,200
Downpayment	\$16,000	\$32,000
Closing costs	\$3,200	\$3,200
Borrower portion	\$19,200	\$19,200
Years to save *	7.5	12 w/o subsidy
Mortgage	\$144,000	\$128,000
Mkt Payment 4.5%	\$ 730	\$ 649
DTI	0.44	0.42
Sub Payment 3.5%	\$ 647	\$ 575
DTI	0.42	0.40
Notes:	<i>100 bps savings from MRB; 10% down</i>	<i>20% downpayment</i>

** 5% of income saved per year; 5% annual return on savings*

Figure 2

Factors for Evaluating Low-income Homeownership Policies

<u>Factor</u>	<u>Key Indicator</u>	<u>Policy Ideal</u>
1. Scalable	What portion of low-income potential first-time buyers are supported annually?	Larger scale (e.g. 10% of target market)
2. Marginal Effect	Does the policy primarily induce people who otherwise would not buy a home to buy a home rather than pushing existing buyers to buy larger homes or borrow larger mortgages (intensive margin)?	Extensive marginal buyer
3. Targeted	Does the policy primarily induce first-time buyers under a certain income level or matching another strategically defined demographic?	Highly targeted
4. Administrative Costs	What portion of the subsidy is required to administer applications, fund transfers and oversight/monitoring (and for how long)?	Low marginal administrative costs
5. Recapture	Does the program have provisions to 'recycle' subsidies for additional buyers and/or revoke subsidies from buyers who fail to meet targeting criteria?	High level of re-use of funds across 3-4 buyers (net of administrative costs)
6. Neighborhood Revitalization	Does the program provide added incentives for the physical improvement of the housing stock in otherwise distressed areas?	Neutral to or promoting acquisition-rehab
7. Default Risk	Does the program develop information useful for underwriting homebuyer risks and/or reduce/mitigate risks post purchase?	Reveal pre-purchase behaviors and create incentives not to default (and to cure in case of delinquency)
8. Mobility Limits	Does the program limit homebuyers from selling or moving if labor market or family contexts change?	Maximum labor market fluidity

Figure 3

Illustration of Low-income Homeownership Policy Criteria: Alternative Policies

	1. Scalable	2. Marginal Effect	3. Targeted	4. Administrative Costs	5. Recapture	6. Neighborhood Revitalization	7. Default Risk	8. Mobility Barrier
MID	Yes	Intensive	No	Minimal	None	None	N/A	No
MRB	Yes	Intensive?	Yes	Moderate	Yes	Minimal	Mixed	Yes
DPA	No	Extensive	Yes	High	Sometimes	Minimal	Lower	No
Price Subsidy	No	Extensive	Yes	Very High	Sometimes	Yes	Lower	Yes
SAVING PROGRAMS	Not currently	Extensive	Yes	Moderate	No	No	Lower	No
CL TRUST	Not currently	Extensive	Yes	High	Yes	Mixed (if new, yes)	Lower	Limited

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