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Housing subsidies and tax expenditures: The case of mortgage credit certificates ☆

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ABSTRACT

In many developed countries, the most significant housing subsidy programs are funded by tax expenditures rather than direct appropriations. Beyond the subsidy to homeownership under the personal income tax, the U.S. tax code provides additional subsidies to specific groups of homeowners. For example, the Mortgage Revenue Bond program (MRB) permits lower levels of government to issue tax-exempt debt, using the proceeds to supply mortgages at below-market interest rates to deserving households. States are also permitted to issue and distribute Mortgage Credit Certificates (MCCs) which entitle recipient homeowners to claim a tax credit for some portion of the mortgage interest paid rather than the tax deduction claimed by other homeowners.

This paper documents the wide variations in reliance upon MCCs and MRBs across U.S. states and the emergence of Mortgage Credit Certificates as the largest housing program administered by California, the largest U.S. state. The paper also provides an economic analysis of the MCC program using micro data on more than 12 thousand program recipients in California. We estimate the extent and distribution of MCC subsidies across income and demographic groups, measuring the dollar amount of federal subsidies and their effects upon the user cost of residential capital and the demand price of housing. We estimate Poisson models of the geographic incidence of MCC subsidies across neighborhoods of varying socio-demographic composition and deprivation. Finally, we note differences in the administrative and programmatic costs of MCCs and MRBs, suggesting that there are clear reasons to favor Mortgage Credit Certificates as a means of subsidizing deserving households.

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1. Introduction

The most significant housing subsidy programs in the U.S. are funded by tax expenditures through the Internal Revenue Code. The special status of owner-occupied housing under the personal income tax is well-known: interest payments for home mortgages are deductible as personal expenses for the first and second homes of taxpayers, up to a limit of one million dollars; *ad valorem* property taxes on owner-occupied houses are also deductible as personal expenses; the implicit rental income from occupying the house (the "dividend") is excluded from gross income; and capital gains are essentially untaxed. Many other developed countries also provide preferential treatment of homeownership through their systems of national taxation (see Englund, 2003, for an international comparison).

Beyond these subsidies to home ownership, which apply to all owner–occupants, the U.S. tax code provides additional subsidies to specific groups of homeowners. These programs are managed by the states, but the source of the subsidy is federal tax expenditures. The tax code permits lower levels of government to issue tax-exempt debt and to use the proceeds for the benefit of specific mortgage holders through the Mortgage Revenue Bond (MRB) program. Recipients benefit by obtaining mortgages which have been issued at the lower tax-exempt interest rate, rather than the market rate.

Finally, U.S. states are permitted to issue and distribute Mortgage Credit Certificates (MCCs), which entitle recipient homeowners to claim a tax credit for some portion of the mortgage interest paid, rather than the tax deduction which can be claimed by other homeowners. Subsidies distributed by states and cities under the MRB and MCC programs are subject to an aggregate cap prescribed in the tax code.

There is a rather extensive literature documenting the economics of income tax subsidies to homeowners (e.g., Berkovec and Fullerton, 1992), and there is a smaller literature on the operation of the MRB subsidy program (e.g., Ling and Smith, 1988). There is little economic analysis of the MCC program. (Indeed we were only able to find one paper describing the program. See Stegman and Stebbens, 1992. There is a fleeting reference to the program in Green, 2001). The MCC program is smaller, but it is by no means unimportant. For example, in the most populous state, California, Mortgage Credit Certificates represent the largest of all state-administered housing programs.

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This paper compares the economic characteristics of these two mortgage subsidy programs, presenting the salient features and the relative advantages of MCCs and MRBs in delivering targeted benefits to deserving recipients. In Section 2, we introduce the history of the programs. In Section 3 we deconstruct the mechanics of the subsidy programs. In this section we simulate the gross and net subsidies to participating households as a function of their incomes, housing choices, and macroeconomic conditions. From the viewpoint of the recipients, we compare the subsidies in terms of additional income and in terms of their affect upon the user cost of housing capital paid by recipients.

In Section 3 we analyze the operation of the Mortgage Credit Certificate program using microeconomic data on program beneficiaries in California. We analyze data on recipients of subsidies under California's MCC program during the 3-year period, 1996 through 1998. The micro data include information on the characteristics of recipient households, their dwellings, and their residential locations. We analyze the geographical distribution of homeowner subsidies and the magnitude and distribution of benefits by location and demographic group. We also analyze the transactions costs of the MCC program in California in comparison to the MCC program.

Our analysis demonstrates that, at least in one U.S. state, the operation of the MCC program does provide highly targeted benefits to households differentiated by income, household size, housing type, and neighborhood. Beneficiaries of the program have household incomes which are, on average, 21% lower than those of the population at large. The households of beneficiaries are slightly larger, and they are more likely to be members of minority groups. Among recipient households, the amount of the subsidy increases very slightly with income and family size. These subsidies are somewhat more concentrated in deprived neighborhoods and subsidies are more likely to be concentrated in census tracts with larger minority populations. The subsidies are not concentrated in the lowest income or highest poverty neighborhoods, but rather in areas with low housing prices and with high homeownership rates.

In Section 3 we also present evidence on the large differences in transactions costs of MCC and MRB programs based upon interviews and surveys in California and the relevant Federal regulations. This facilitates a comparison of the productive efficiency of the programs, suggesting the differences in the number of households who can be subsidized in each program at equal cost to the federal treasury.

Our analysis suggests that there would be substantial benefits to expanding the MCC program at the expense of the MRB program. Credit certificates offer considerable advantages in terms of efficiency, flexibility responsiveness to local needs, and this subsidy can be highly targeted. We suggest that with one minor change, the credit certificate program would unambiguously dominate the bond program.

2. MRBs, MCCs and Private Activity Bonds

State Mortgage Revenue Bond Programs, authorized by the Revenue and Expenditure Control Act of 1968, permit state and local governments to issue tax-exempt bonds and to use the proceeds to provide below-market interest rate mortgages to “deserving” (i.e. low- and moderate-income) homebuyers. Mortgage payments retire the bond issues, which are guaranteed by state governments.

By the early 1980s, widespread dissatisfaction had developed with MRB programs. In 1983 the U.S. General Accounting Office (GAO) reported that only 26% of MRB costs to taxpayers subsidized deserving homebuyers, while the remaining 74% benefited governments, bond purchasers and market intermediaries (GAO, 1983b, 7). Bond proceeds were poorly targeted; 78% of 1982 recipients had incomes above the local median (GAO, 1983b, 8): most buyers assisted under MRB programs could have purchased the same homes at the same time without assistance (GAO, 1983b, 10). Further, MRB programs were inherently inflexible. Subsidies could not be adjusted if recipients' incomes changed after purchasing a home; the reduced mortgage interest rates were fixed for the term of the loan, despite fluctuating market interest rates. Housing finance agencies (HFAs) could not select among loan applicants based on need (GAO, 1983b, 13).[1]

Policymakers became concerned about the effects of MRBs on interest rates and the costs of other government programs. An Urban Institute study estimated that the interest rates of *all* tax-exempt bonds increased by 4–7 basis points with every billion dollars of new tax-exempt housing bond issues (GAO, 1983a, 9–10).

Congress responded to these concerns in the Deficit Reduction Act of 1984, creating the Mortgage Credit Certificate (MCC) alternative and allowing HFAs to substitute MCCs for MRB authority. Congress intended MCC programs to be more efficient, less costly and less prone to interest rate risk than their MRB counterparts. Since MCCs do not require underwriters, forward commitment fees or loss reserves, they have lower transactions costs. A greater percentage of the subsidy's benefits thus go to the intended recipients.

The Tax Reform Act of 1986 (TRA86) affected the MRB and MCC programs by introducing a state ceiling on the annual volume of activity and by introducing further targeting restrictions. TRA86 combined existing bond volume caps into a single Private Activity Bond (PAB) allocation. The PAB allocation to any state limits the amount of tax-exempt bonds that can be issued for “private purposes,” e.g., those issued to benefit specific private entities, such as individual homeowners. Until 2002, the cap was set at the larger of $225 million per state or $75 for each resident of the state. Beginning in the fiscal year 2003, this ceiling has been adjusted annually for inflation.

The Private Activity Bond cap awarded to each state may be used to subsidize housing and a variety of eligible programs.[2] Housing bonds include those issued for the construction of multifamily housing as well as the MRB and MCC programs for homeowners described above. The allocation of the PAB bond cap among these programs is determined freely by each state, and the priorities among states may vary substantially.

Table 1 reports the national distribution of Private Activity Bonds between housing and other programs during the period 1992–2003. As the table indicates, of $202 B in newly available bond authority, about $71 B was allocated to uses other than housing, and about $51 B was unallocated by state authorities. The remainder, about $80 B, was allocated to housing programs—49% to multifamily housing and 51% to homeownership programs. One-fourth of the subsidy to homeownership during this period allocated through MCCs, with the remainder allocated through MRBs.

As the table indicates, the allocation of bond authority among programs has varied quite substantially over time. The division between housing programs and other qualified activities has changed frequently, as has the division between multifamily housing programs and those supporting homeownership. Annual allocations to Mortgage Revenue Bonds have ranged between $496 M and $4641 M across years; allocations to Mortgage Credit Certificates have ranged between $345 M and $1413 M.[3]

This considerable variation over time is less pronounced than is the geographical variation in the utilization of these forms of bond authority.

[1] The inadequate targeting of subsidies meant that many recipients would have soon become homebuyers even without MRB assistance; the lower-rate mortgages simply sped up their buying process or else allowed them to purchase greater amounts of housing services. GAO's 1998 study of MRB recipients reported that 23 out of 25 HFAs interviewed admitted that they did *not* try to direct MRB loan subsidies to households who could not otherwise buy homes, (GAO, 1998, 4).

[2] Programs eligible to use private activity bonds include Tax Exempt Facilities (to benefit public enterprises such as airports, sewage disposal facilities, etc.), Industrial Development Agencies (to develop industrial or commercial properties for the benefit of private owners), Student Loans (to finance higher education), and Housing Bonds. These programs are specified in Sections 141 through 147 of the IRC.

[3] PAB authority is allocated to issuers of revenue bonds or credit certificates by state governments. Issuers of MCCs issue certificates whose aggregate authority-use value is one-fourth of the debt allocation received (see IRC 26d). The authority-use value of each certificate is its loan amount multiplied by its eligible tax credit rate. The rule of one-fourth is a rough approximation to aggregate tax loss from a newly awarded certificate (the annual subsidy declines as the loan is amortized, and the weighted-average maturity of mortgage loans is 6–8 years).

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