The Goldilocks Dilemma of Moderate-Income Housing Subsidies: Finding the "Just Right" Amount for the Missing Middle

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Introduction

The question presented—whether federal, state, or local governments should subsidize housing costs for moderate-income[1] households—forces us to confront tradeoffs between competing policy priorities in the presence of limited funding. Although it might be useful to speculate about a world where housing was considered a basic human right for all, and the federal government made a robust commitment to affordable housing for all, such a world is unlikely in the near future. In a world where incomes were adequate or housing was inexpensive, very few households at all would need any housing subsidies, but such a world is also unlikely in the near future. For purposes of this argument, however, we shall deal with the practical world of policymaking, taking existing institutional arrangements as given. Given limited budgetary resources, because I argue that some moderate-income households should potentially receive some housing subsidies, I also have to argue about where those resources should come from and the likelihood of such a policy being implemented.

This article is organized as follows. First, I try to expand the definition of subsidies for housing costs to include tax expenditures and to argue that our current housing subsidy system is poorly targeted. Second, I provide more information on which households are included in the 80- to 120-percent-of-median group and how their incomes relate to housing costs. Finally, I recommend those types of policies and conditions under which moderate-income households should be eligible for housing subsidies, and how to pay for them.

[1] The specific question refers to households that have incomes of between 80 and 120 percent of the U.S. Department of Housing and Urban Development (HUD) Area Median Family Income (HAMFI, or AMI). For ease of exposition, I refer to these households as "moderate-income" households throughout this article.

What Are Housing Cost Subsidies?

What do we mean by *subsidies* for housing costs? Citizens and policymakers will likely first think of direct expenditures such as tenant- or project-based rental assistance programs for owners or developers of affordable rental housing. Perhaps they might also think of the Low-Income Housing Tax Credit program as subsidizing the production of affordable housing.

Most would probably not consider housing tax expenditures—the mortgage interest deduction for owner-occupied housing, the exclusion of capital gains on the sale of principal residences, and the deductibility of local property taxes (JCT, 2015)—to be subsidies. Most would also not consider mortgages financed by the housing-related government-sponsored enterprises (GSEs) or insured by the Federal Housing Administration (FHA) to be a form of subsidy.

Therefore, in the common language of housing policy, we tend to think that *subsidized housing* consists of programs targeted toward lower-income households, while we do not call the extensive tax benefits to middle- and upper-income households "subsidies."

The crux of my argument that governments could subsidize moderate-income households depends on a more robust definition of subsidy than how that term is commonly understood. Whereas the budgetary or legal definition of a subsidy may be narrower (limited to direct payments), the economic effects of a direct payment and of a reduction in tax liability on behavior at the margin should be similar. If a direct payment or a tax deduction has the same impact on the net cost of capital, individuals and firms should be indifferent as to whether they receive a subsidy or a tax deduction.

International policy bodies recognize this broader definition of subsidy. A recent study on housing subsidies by the Council of Europe included tax expenditures as constituting housing subsidies (Council of Europe, 2008). Likewise, the World Trade Organization Subsidies and Countervailing Measures Agreement defines subsidies to include "foregone [government] revenues that are otherwise due" (WTO, 2006: Article 1.1(a)(1)).

Thus the debate over the targeting of housing subsidies by household income levels should include tax expenditures and the indirect effects on housing costs of the GSEs, FHA, and similar institutions at the state and local levels (such as state housing finance agencies [HFAs]).

When considered under this broader definition, the majority of housing subsidy dollars in the United States are poorly targeted toward middle- and upper-income households—those earning more than $100,000 adjusted gross income (AGI)[2]—rather than toward lower-income households. In any given year, more housing subsidy dollars flow to those households with an AGI of more than $100,000 than the entire proposed fiscal year (FY) 2016 budget of the U.S. Department of Housing and Urban Development (HUD), for example.[3]

[2] Using data in JCT (2015), Table 3 (Distribution by Income Class of Selected Individual Tax Expenditure Items), I estimate that households with estimated AGI-Plus (details of income estimation are in the report) greater than $100,000 in calendar year 2014 received $24.5 billion in real estate tax deductions and $59.2 billion in mortgage interest deductions. For comparison purposes, households with incomes of less than $100,000 received only $5.7 billion in real estate tax deductions and $13.1 billion in mortgage interest deductions.

[3] See the previous footnote for calculations showing $83.7 billion in tax expenditures to households with AGI exceeding $100,000. The FY 2016 proposed HUD budget was $49.3 billion. https://archives.hud.gov/news/2015/pr15-013.cfm.

Who Are Moderate-Income Households?

One way to think about moderate-income households is that their incomes are too high to qualify for low-income housing programs but too low to take full advantage of housing-related tax deductions.[4] These households may represent the "missing middle" in housing policy.

I have been using the term moderate-income households to refer to households with incomes between 80 and 120 percent of area median income (AMI). To make clear which households are in view, exhibit 1 presents the FY 2016 income limits for 80-percent and 120-percent reference households (four persons per family) for the 10 largest metropolitan areas in the United States.[5] For comparison purposes, exhibit 1 also presents the most recent (2015) census figures for median house price and median annual gross rent.[6]

In all of the 10 metropolitan areas detailed in exhibit 1, a four-person family at an income level of 80 percent of AMI could afford the median metropolitan gross rent under standard definitions of

Exhibit 1

FY 2016 80- and 120-Percent Area Median Income Limits (four-person households) and CY 15 Median House Price and Median Annual Gross Rent

Metropolitan Area	HUD Area Income Limits (HAMFI)		Median House Price ($)	Median Annual Rent ($)
	80-Percent Limit ($)	120-Percent Limit ($)		
New York	72,500	108,750	414,000	15,696
Los Angeles	69,450	104,175	540,600	16,176
Chicago	61,500	92,250	224,300	12,144
Dallas	57,350	86,025	172,500	11,904
Houston	55,350	83,025	168,300	11,736
Washington	70,150	105,225	401,500	18,636
Philadelphia	64,250	96,375	240,900	12,744
Miami	56,800	85,200	241,700	14,496
Atlanta	54,000	81,000	186,300	12,180
Boston	73,050	109,575	393,000	15,792

CY = calendar year. FY = fiscal year. HAMFI = HUD Area Median Family Income. HUD = U.S. Department of Housing and Urban Development.
Note: CY 2015 house price and rent data are from 2015 American Community Survey (ACS) 1-year estimates of median value of owner-occupied housing and median gross rent.
Sources: FY 2016 Income Limits Briefing Materials; 2015 ACS; author's calculations

[4] This definition is a little imprecise, but generally true. Again, using JCT (2015), Table 2 indicates the percentage of returns by income category that itemized deductions. For households making between $75,000 and $100,000 (which roughly corresponds to moderate-income households), only 49 percent itemize deductions, whereas for households making more than $100,000, 75 percent of returns show itemized deductions. Slightly more than 7.2 million households making between $75,000 and $100,000 itemized deductions, and the value of the mortgage interest deduction for these households was $6.9 billion (JCT, 2015: Table 3). This total equates to an annual average mortgage interest deduction per moderate-income household of $953. By contrast, the annual average mortgage interest deduction per itemized return for households making more than $100,000 was $2,354.

[5] For consistency purposes, the 120-percent income limits are estimated as 150 percent of the value of the 80-percent limits.

[6] The correlations between income levels and house prices and rents varies between 0.78 and 0.86, conforming to basic urban economic realities that these variables, across metropolitan areas, are highly correlated. This high level of correlation is a reason why targeting housing programs based on AMI rather than federal poverty level is appropriate. These correlations, however, also indicate why federal tax expenditures for housing based on AGI rather than AMI are poorly targeted spatially, because higher levels of subsidy go to people who reside in areas with more expensive housing.

affordability (paying no more than 30 percent of income on gross rent). Affordability at the median rent does not mean no cost-burdened, moderate-income renter households live in these metropolitan regions. Although Comprehensive Housing Affordability Strategy (CHAS) data are not available at the metropolitan level, a quick survey of the central counties of these metropolitan areas shows thousands of moderate-income renter households that experience rental cost burdens. However, as a percentage of all cost-burdened renter households in these metropolitan areas, moderate-income households represent a small fraction.[7] Median statistics at the metropolitan level also obscure the spatial variation between incomes and housing costs within each region.

Likewise, under very strong assumptions,[8] a four-person family making 80 percent of AMI could "afford" the median-priced house in all the metropolitan regions in exhibit 1, with the exception of Los Angeles. These strong assumptions—particularly that households are able to accumulate substantial enough savings for a 20-percent downpayment, have an adequate credit history, and fall under Dodd-Frank's[9] aggregate debt-to-income ratio caps—illustrate the current challenge facing many moderate-income households in acquiring homeownership. Even though the median house may appear affordable, in practice it is not accessible to moderate-income households. I will return to this theme in the Policy Recommendations section.

From both a moral/ethical and a political point of view, providing housing subsidies to households making $90,000 annually in the Philadelphia suburbs or to households making $100,000 annually in the Boston suburbs seems problematic, especially when compared to providing housing assistance to police officers or teachers in urban areas who might make $45,000[10] a year, for example. Housing policy, like nearly all social policy in the United States, is complicated by deeply ambiguous ideas of who "deserves" various forms of assistance. When most housing assistance is delivered through the tax code, the deservedness of the recipients is obscured.

On the other hand, high housing costs and mortgage credit constraints significantly impact the ability of moderate-income households to acquire safe, affordable, and healthy housing in high-opportunity neighborhoods. Many senior citizen homeowners might have incomes that qualify them as moderate income, but their ability to access credit markets for rehabilitation of their homes (either for sustainability or accessibility) may be limited. Some first-time homebuyers

[7] For example, using CHAS 2009–2013 data for Cook County, Illinois, fewer than 20 percent of 80- to 100-percent-of-median income renter households were cost burdened, whereas I estimate that 68 percent of all renter households with incomes of less than 80 percent of AMI in Cook County are cost burdened. Of all the cost-burdened renter households in Cook County, those making between 80 and 100 percent of AMI represent only 3.7 percent (huduser.gov/portal/datasets/cp/CHAS/data_querytool_chas.html).

[8] I estimate the maximum house value that would be affordable with a maximum allowable mortgage for the 80-percent-of-AMI household with an assumption that a household has a credit history and aggregate debt-to-income ratio to qualify for the best-available national average rate for a 30-year fixed mortgage of 3.5 percent (using Freddie Mac's Primary Mortgage Market Survey as of Sept. 15, 2016), with a 20-percent downpayment and no property taxes, insurance, or homeowners' association fees.

[9] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203.

[10] According to the 2015 Occupational Employment Survey from the U.S. Bureau of Labor Statistics, secondary school teachers (occupational code 25-2013) at the 10th percentile of annual wages make $43,630 in the Philadelphia metropolitan area and $47,290 in the Boston metropolitan area. Police and sheriff patrol officers (occupational code 33-3051) at the 10th percentile of annual wages make $46,510 in the Philadelphia metropolitan area and $45,140 in the Boston metropolitan area.

might have incomes that qualify as moderate, but they are credit constrained because of student loan debts. In many cases, we can demonstrate that moderate-income households could benefit substantially from housing assistance at the margin, even though some people may perceive their income levels as too high to be in need of welfare. The ambiguity of housing policy is that we talk of subsidized housing as part of the means-tested social welfare system, and we talk about homeownership as the American Dream, but tax-expenditure subsidies meant to support homeownership are mostly used by upper-income households.

Policy Recommendations

Should federal, state, and local governments subsidize moderate-income households' housing costs? Yes. However, any new policy or program or change to an existing policy or program to help moderate-income households with their housing costs must absolutely not do so at the expense of assistance to low-, very low-, and extremely low-income households, whose housing needs are poorly met with existing policies. In fact, I would much prefer that governments at all levels expand housing assistance to lower-income households before expanding assistance to moderate-income households. As part of a comprehensive housing reform and reinvestment package, however, some assistance targeted toward moderate-income households would be warranted and may help build broader support for policy changes. In this section, I outline a few instances in which targeted assistance to moderate-income households would be appropriate.

To pay for policy changes that would help moderate-income households with their housing costs (and introduce more equity and efficiency in the housing finance system), I suggest slowly (maybe over 5 to 10 years) phasing out the mortgage interest deduction and the deductibility of local property taxes. Many tax deductions and credits already phase out at higher income levels. Although I have not studied the level at which the phase-out should begin, I imagine it could be somewhere over $200,000 AGI. More specifically, econometric research along the lines of Hilber and Turner (2014) could identify the income level at which the deductibility of mortgage interest does not marginally impact tenure decisions. Any additional revenue from better targeting of the mortgage and property tax deductions could go to increased vouchers for low-income households, deficit relief, and targeted assistance to moderate-income families.

I also suggest a renewed commitment at the federal level to assist moderate-income households, and first-time homebuyers in particular, with sustainable homeownership opportunities by taking lessons learned from previous policies and programs into consideration. For example, programs such as the American Dream Downpayment Initiative, which was available only to households making less than 80 percent of AMI, might be better targeted if it included moderate-income households. The government could also reintroduce a first-time homebuyer credit that targets moderate-income households.

In truth, a lot of innovation and activity is already under way in providing credit products for homeownership targeted toward moderate-income households. For example, Fannie Mae has a "Home Ready" mortgage product with up to a 97-percent loan-to-value ratio and income limits up to 100 percent of AMI.[11] My own state's HFA, the Wisconsin Housing and Economic Development Authority, has a Fannie Mae Advantage product available for first-time homebuyers with income limits up to 115 percent of AMI.[12] Other products targeting a similar market are available through other state HFAs and many lenders in the Federal Home Loan Bank system. The federal government could provide targeted tax credits or downpayment assistance to increase uptake of the wide array of available products.[13]

The federal government could direct assistance through state and local governments and local housing authorities to provide flexibility in adjusting housing assistance to local conditions and as an incentive for state and local governments to provide some cost sharing. Local governments could use federal resources to expand downpayment assistance programs to include moderate-income households.

In addition to assistance targeted toward moderate-income first-time homebuyers, homeowners increasingly need financial assistance or credit products designed to incentivize energy-efficient, sustainability, or accessibility investments in their homes. I envision something akin to the Better Housing Program in the 1930s, the less-well-known program of FHA, which provided financing for existing homeowners to make improvements to their houses (Hutchinson, 2000). Many local governments already have low- or no-interest loan programs to help moderate-income households, seniors, or both make modest repairs to their houses, but a consistent and targeted federal financing program could unleash significant reinvestment and upgrades of the older housing stock in many areas of the country.

I write this article not only as an academic, but also as a member of my city's housing committee. Like many local governments around the country, the City of Middleton, Wisconsin has many partnerships with local housing providers and nonprofit agencies and provides a range of programs (such as downpayment assistance and modest home loans) to help seniors stay in their homes, to help modest-income workers afford housing in the city, and to encourage homeowners to rehabilitate older housing stock. Like many local governments, the city's funding is limited, so it targets financing to programs that leverage state and local dollars. Even a small federal investment in financing programs targeted toward moderate-income households to rehabilitate older housing stock—with flexibility for local innovation and partnerships—would encourage significant reinvestment in housing.

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[11] See https://www.fanniemae.com/content/fact_sheet/homeready-product-matrix.pdf for more information.

[12] See https://www.wheda.com/WorkArea/DownloadAsset.aspx?id=432 for more information.

[13] I am aware of the complexity of underwriting these products in the context of ability to repay and Qualified Mortgage regulations, but addressing these regulations is beyond the scope of this article.

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