Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

Special Series: **Economic Recovery Watch**

October 27, 2009

PROPOSED EXPANSIONS OF HOMEBUYER TAX CREDIT WOULD BE HIGHLY INEFFICIENT AND SQUANDER FEDERAL RESOURCES

By Douglas Rice and Robert Greenstein

Executive Summary

Members of Congress are considering extending — and possibly substantially expanding — the $8,000 homebuyer tax credit enacted as part of the American Recovery and Reinvestment Act (ARRA) of 2009. The credit, which is available to first-time homebuyers with incomes up to $150,000 (up to $75,000 for individuals), expires on December 1 of this year.

The evidence strongly indicates that Congress should show restraint, especially in considering expansive versions of the legislation. Given the continuing weakness in the economy and in housing markets, well-designed stimulus for the housing sector is appropriate. But while there is evidence that the existing homebuyer tax credit has stimulated some additional home-buying activity, the program has proven to be very inefficient. And the proposed expansions of the credit would make it dramatically more inefficient, with a very low "bang for the buck" in stimulating more home sales and helping the economy.

The vast majority of tax-credit benefits have gone to families that would have purchased a home anyway, even without the credit. The National Association of Realtors (NAR), which supports expanding the credit, estimates that between 350,000 and 400,000 additional home buyers have entered the market in response to the tax credit. But the NAR also estimates that 1.8 to 2.0 million purchasers will claim the tax credit. Thus, under the NAR estimates, *for every homebuyer who purchases a home as a result of the tax credit, there are another four receiving the credit who would have purchased a home anyway.* As economist Ted Gayer at the Brookings Institution has noted, this implies that the current homebuyer credit will cost taxpayers $15 billion in lost revenues, or $43,000 for each additional home sold.

Moreover, the NAR estimates likely *understate* the tax credit's inefficiency. A new assessment by Goldman-Sachs finds that "The credit seems unlikely to generate more than half of the NAR's estimate or around 200,000 [additional homebuyers]."[1] This suggests a cost closer to $75,000 for each additional house purchased.

Expanding — rather than simply extending — the homebuyer credit would make it much more costly and inefficient than it already is in generating home sales, reducing the inventory of unsold homes, and stabilizing home prices:

- Senators Johnny Isakson and Chris Dodd have put forth a proposal to expand eligibility for the tax credit to *all* homebuyers — not just first-time homebuyers — with incomes up to *$300,000* (up to $150,000 for individuals). Gayer estimates that this proposal would cost taxpayers $17.8 billion in lost revenue, or *more than $250,000 per additional home sale.*

- An even more expansive bill introduced earlier by Senator Isakson (S. 1230) would replace the existing tax credit with a credit worth up to $15,000 to any homebuyer, with no income limit whatsoever. According to Gayer's calculations, the Isakson bill would cost taxpayers up to $323,000 per additional home sale generated by the credit.

Furthermore, expanding the credit to people who already are homeowners will do little to reduce the excess inventory of homes or to stabilize home prices. When existing homeowners purchase a new home, they simultaneously put their current home up for sale. As a result, there is no net effect on supply or demand in the housing market. For similar reasons, expanding the homebuyer credit to higher income households also would be unproductive, because more than 90 percent of households with incomes of $120,000 or more are already homeowners.

Adding to these problems is growing evidence of abuse of the tax credit. The Government Accountability Office reported last week that the "IRS faces significant implementation and compliance challenges related to the FTHBC" [the First-Time Homebuyer Tax Credit].[2]

Fundamental to Congress's decision to extend the homebuyer tax credit should be a calculus of how much additional stimulus spending is needed, to what extent such spending should be targeted on the housing sector, and which actions would be most cost effective.

There already is a significant amount of stimulus going into the housing sector, most of which is benefitting homeowners and homebuyers. Large programs include Federal Reserve and Treasury purchases of Fannie Mae and Freddie Mac securities, home buyer assistance through the Home Affordable Modification Program and the Home Affordable Refinance Program, and neighborhood stabilization funds and other housing program funds included in the economic recovery legislation enacted in February. Some analysts have concluded that these other measures have played a larger role than the homebuyer tax credit in bringing buyers into the market.[3]

Policymakers should concentrate on measures that provide the most "bang for the buck" in boosting the economy and creating or preserving jobs. Such measures include extending federal

---

[1] Goldman Sachs Global ECS US Research, "Housing Policies and Home Prices," October 23, 2009.
[2] Government Accountability Office, "First Time Homebuyer Tax Credit: Taxpayers' Use of the Credit and Implementation and Compliance Challenges," GAO-10-166T, Oct. 22, 2009.

[3] See, for example, the comments of Sam Khater, senior economist from First American Core Logic Inc., as reported in Conor Dougherty and John D. McKinnon, "Tax Credit Fuels Rise in Home Sales," *Wall Street Journal*, Oct. 24-25, 2009.

unemployment benefits and providing additional fiscal relief targeted to states that are facing the most severe economic and budget problems. The vast bulk of the resources used to expand the homebuyer tax credit would go to people who would purchase a home anyway. In contrast, additional resources provided to strapped states that must close large, recession-induced budget deficits would go dollar for dollar to avert layoffs, budget cuts, and tax increases that reduce demand in the economy and cost jobs.

Finally, if Congress decides some further intervention in the housing sector is warranted, it should consider providing additional assistance to families at risk of foreclosure or eviction due to job losses. Preventing a foreclosure generally has the same net effect on the home market as converting a renter to a homeowner does. Similarly, providing assistance that enables families living in homeless shelters or "doubled up" with other families to move into permanent apartments reduces vacancies in the rental housing market.

Background

Congress first authorized the refundable homebuyer tax credit in the Housing and Economic Recovery Act of 2008 (HERA), enacted in July of that year. In the recovery legislation enacted in February 2009 (ARRA), Congress expanded the tax credit, waiving repayment of the credit if the home purchaser holds on to the property for at least three years and slightly increasing the amount of the credit from $7,500 to $8,000. Under both HERA and ARRA, a full tax credit is available to married couples with incomes up to $150,000 (and individuals with incomes up to $75,000), with the credit phasing out at incomes above these levels.

Congress is now considering an extension of the tax credit, which expires at the end of November 2009. Legislation to extend it through May 2010 has been introduced by Senator Ben Cardin (D-MD), with cosponsors Senators Harry Reid (D-NV), John Ensign (R-NV), Debbie Stabenow (D-MI), and Johnny Isakson (R-GA) (S. 1678). Several bills have been introduced in the House to achieve the same purpose. At this stage, the credit appears headed toward renewal although some voices have raised concerns about the credit's effectiveness and cost.

More costly proposals to expand the homebuyer credit also have been introduced in both the House and Senate. The more expansive proposals generally would allow all homebuyers — not just first-time homebuyers — to claim the credit. Some also would make the credit available to individuals and households with incomes well above the current threshold of $150,000, or would extend the credit for a full year. Some also would increase the dollar amount of the credit.

Existing Credit Is Costly, Inefficient, and Limited in Impact

The homebuyer tax credit has generated some additional home sales, thereby helping to reduce the large inventories of unsold homes and to stabilize falling home prices. Recent data call into question the cost-effectiveness of the tax credit, however, and numerous analysts have observed that the nation is paying a hefty price for a relatively modest increase in demand.

The National Association of Realtors (NAR) estimates that 350,000 to 400,000 more homebuyers have entered the market due to the credit, but that 1.8 million to 2.0 million home purchasers will claim the credit against their tax liabilities.[4] Under these data, about four of every five homebuyers who claim the credit would have bought their homes without it. Moreover, even this figure overstates the credit's beneficial effect — this estimate of "additional" homebuyers includes many who have simply accelerated purchases that they would have made in 2010 or 2011 if the credit had not been available.

Economist Ted Gayer at the Brookings Institution notes that if the NAR estimates are correct, the homebuyer credit will cost the federal government about $15 billion in lost revenue — or about $43,000 for every home purchase that would not otherwise have occurred.[5] This makes the credit an inefficient and costly subsidy. Gayer also notes that the homebuyer tax credit is doing relatively little to help absorb excess housing inventory.

In addition, some other analysts believe the NAR estimates are inflated. Goldman-Sachs estimates that no more than 200,000 additional homebuyers have made home purchases because of the tax credit.

Nor does the evidence support claims that the homebuyer credit is a good way to create jobs. Estimates from the National Association of Home Builders indicate that more than four of every five homes purchased with the tax credit will be *existing* homes rather than newly constructed ones.[6] This suggests the job creation effect of the credit is limited.

Furthermore, if as some experts suspect, a large number of first-time homebuyers using the credit have accelerated purchases they otherwise would have made in 2010 and 2011, then sales and prices — and the credit's modest job creation effects — may drop off to some degree even if the credit is continued.[7] A related concern is that to the extent that the homebuyer credit has converted renters to owners, it has added to vacancies in the rental housing market, weakening an important part of the housing sector that also has experienced considerable softening in recent months.[8]

Finally, there is a danger that if the credit is both extended and expanded, political pressure could build over time to make the tax credit permanent, as participants in the market get used to its availability. That would make the long-term deficit problem even greater (as well as add to the already rich support for home purchases in the tax code).

Expanded Versions of the Homebuyer Credit Would Increase Cost and Inefficiency

In light of these questions about the cost and efficacy of the existing homebuyer tax credit, it is troubling that Congress is considering much more expansive — and expensive — versions of the

[4] "Pending Home Sales on a Record Roll," NAR press release on September 1, 2009; see http://www.realtor.org/press_room/news_releases/2009/09/record_roll. Other observers, such as the National Association of Home Builders, have calculated the effect of the tax credit to be much smaller, though still significant.

[5] Ted Gayer, "Should Congress Extend the First-Time Homebuyer Tax Credit?," Brookings Up Front Blog, September 24, 2009; available at http://www.brookings.edu/opinions/2009/0924_tax_credit_gayer.aspx.

[6] Paul Emrath, "Economic Effects of a Policy to Stimulate Home Buying," HousingEconomics.com, January 9, 2009.

[7] Economist Dean Baker makes this argument in his September 2 issue of *Housing Market Monitor* ; available at http://www.cepr.net/index.php/data-bytes/housing-market-monitor/surge-in-sales-in-west/.

[8] Put another way, the homebuyer credit does little to reduce the excess supply of housing overall; instead, it merely shifts vacancies from the homeowner market to the rental market. See Gayer, op cit.

credit. In June, Senator Isakson and nine co-sponsors introduced a bill (S. 1230) that would replace the existing tax credit with a one-year credit worth up to $15,000 to *any* homebuyer — not just to first-time homebuyers — at *any* income level. More recently, Senators Dodd and Isakson have proposed expanding eligibility to all homebuyers (not just first-time buyers) with incomes up to $300,000 (or $150,000 for individuals), as well as extending the credit for seven months.[9]

The Dodd-Isakson proposal would carry considerable costs. According to media reports, the Joint Committee on Taxation has estimated the cost of this credit at $16.7 billion, roughly in line with the independent estimate of $17.8 billion generated by Ted Gayer of Brookings. Gayer also calculates that each additional home sale generated under this proposal would cost taxpayers more than $250,000. (The cost to taxpayers of each additional home sale would be lower under more optimistic assumptions but would still exceed $100,000.[10])

Expanding the homebuyer credit to people who already are homeowners also would do little to reduce the excess inventory of homes or to stabilize home prices. When existing homeowners purchase a new home, they simultaneously put their current home up for sale. As a result, while making the homebuyer credit available to existing homeowners may increase the number of sales transactions, it would have little net effect on supply or demand in the housing market. For similar reasons, expanding the homebuyer credit to higher income households would also be ineffective, as more than 90 percent of households with incomes of $120,000 or more are already homeowners.[11]

Finally, extending eligibility for the credit beyond first-time homebuyers would ensure that more of the benefits flow to less needy families, as first-time homebuyers are more likely to have modest incomes than other homebuyers.[12]

Other Measures Would Do More to Support Housing Sector and the Economy

Fundamental to Congress' decision to extend the homebuyer tax credit should be a calculus of how much additional stimulus spending is needed, to what extent such spending should be targeted on the housing sector, and which actions would provide the most "bang for the buck."

As explained above, the current homebuyer credit is already inefficient. But because it is limited to first-time homebuyers, it is better targeted, more likely to make a difference in the decision regarding whether to purchase a home, and more likely to result in other household expenditures (like new furniture purchases that accompany a first home) than a much broader homebuyer tax credit would be. Expanding the tax credit, especially to people who are not first-time homebuyers and people with incomes above $150,000, would make the credit considerably less cost effective

---

[9] Ted Gayer, "Extending the Homebuyer Tax Credit Is a Bad Idea," posted on the Brookings Up Front Blog on October 9, 2009; available at http://www.brookings.edu/opinions/2009/1009_homebuyer_gayer.aspx.

[10] Ted Gayer, "More on the Homebuyer Tax Credit," Brookings Up Front Blog, October 14, 2009; available at http://www.brookings.edu/opinions/2009/1014_home_tax_credit_gayer.aspx. The estimate of $100,000 uses Gayer's methodology but makes a more optimistic assumption about the price elasticity of home sales that Gayer derives from estimates reported by the National Association of Home Builders.

[11] 2007 American Housing Survey.

[12] Data from the 2007 American Housing Survey show that 48.5 percent of first-time homebuyers had incomes below $50,000, compared to 35 percent of repeat buyers.

than it already is. Accordingly, Congress should do no more than extend the current tax credit for an appropriate period of time.

Two other measures — extending federal unemployment benefits and providing additional fiscal relief to states — would provide a more cost-effective boost to the economy. Budget shortfalls have compelled at least 41 states to cut funding for education, health care, and services to the elderly and disabled and have led 30 states to raise taxes.[13] Such actions further withdraw demand from an already weak economy. For example, when states cut spending, they lay off state employees and cancel contracts with, or cut payments to, vendors and service providers, causing a loss of jobs.

Finally, if Congress determines that further intervention in the housing market is warranted beyond temporarily extending the homebuyer tax credit, it should examine other policy interventions to increase demand for housing and absorb some of the excess inventories. These include providing assistance to help people to remain in their existing homes when they are at risk of foreclosure or eviction, and to help people who are homeless find stable housing of their own. Preventing a foreclosure has the same net effect on the home market as converting a renter to a homeowner does. Similarly, providing assistance that enables families living in homeless shelters or "doubled up" with other families to move into permanent apartments effectively reduces vacancy rates in the rental housing market.

Indeed, the rental housing market has been largely ignored by policymakers, even though the rental vacancy rate has risen to a record high of 10.6 percent. Moderate rental vacancy rates may be beneficial, since they help keep rents affordable. Very high vacancy rates, however, can sharply reduce rent collections for landlords, many of whom are small property owners who rely on rental income for part of their livelihood. Lower rent revenues may also make it difficult for owners to maintain properties in good condition, creating blight that can have powerful negative effects on the surrounding neighborhoods. Finally, a glut of rental housing can serve to drag down prices in the homeownership market. Policies that help fill vacant rental units thus can be beneficial.

Reducing the number of foreclosures and providing rental housing to families that would otherwise be homeless also would do more to soften the harshest effects of the economic downturn than encouraging securely housed families to "trade up" their homes, which is the primary effect of the homebuyer tax credit. Children in particular would benefit from such measures, since homelessness and housing instability have been found to result in serious health problems for children, undermine school performance, and have other harmful developmental effects.

---

[13] See Nicholas Johnson, Phil Oliff, and Jeremy Koulish, "An Update on State Budget Cuts," and Elizabeth McNichol and Nicholas Johnson, "Recession Continues to Batter State Budgets; State Responses Could Slow Recovery," Center on Budget and Policy Priorities, October 20, 2009; available at http://www.cbpp.org/research/index.cfm?fa=topic&id=40#.