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# In Search of Smarter Homeowner Subsidies

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IN SEARCH OF SMARTER HOMEOWNER SUBSIDIES  
(*WORK IN PROGRESS*)<sup>1</sup>

*Matthew J. Rossman*<sup>2</sup>

INTRODUCTION

The opportunity to own one's home has long been considered part and parcel of the American Dream. Homeownership, so it is contended, provides a pathway to upward mobility, fosters good citizenship and is a reliable form of long-term savings.<sup>3</sup> Even in the wake of the recent foreclosure crisis, a complex phenomenon in which homes plunged millions of American households into financial distress, the nation has by and large kept the faith in homeownership.<sup>4</sup>

For the last century, the federal government has unabashedly promoted homeownership. It supports credit markets to help make home mortgages affordable, offers counseling and financial assistance to prospective low income homebuyers and, most pertinent to this article, provides a collection of income tax breaks directly to homeowners. These tax breaks (which this article will refer to as "homeowner subsidies") are no small matter. In 2017 alone, it is estimated that the three principal homeowner subsidies – the mortgage interest deduction, the property tax deduction and the exclusion of home sale capital gains – will total \$135 billion in forgone tax revenue.<sup>5</sup> This amounts to the country's second largest

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<sup>2</sup> Professor of Law, Case Western Reserve University School of Law. I would like to acknowledge the very helpful feedback I received from participants at the 2017 Developing Ideas Conference at the University of Kentucky College of Law and the 2017 Clinical Law Review Writers' Workshop at New York University School of Law. I also want to thank the Social Justice Institute of Case Western Reserve University for providing funding to support my research in connection with this article. Its content is my sole responsibility and does not necessarily represent the views of the Social Justice Institute or Case Western Reserve University.

<sup>3</sup> See, e.g., *Social Benefits of Homeownership and Stable Housing*, NATIONAL ASS'N OF REALTORS (April 2012), <https://www.nar.realtor/sites/default/files/social-benefits-of-stable-housing-2012-04.pdf>.

<sup>4</sup> Eric S. Belsky, *The Dream Lives On: The Future of Homeownership in America 2* (Joint Cent. for Housing Stud. of Harv. Univ., Working Paper No. 13-1, 2013), [http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/w13-1\\_belsky\\_0.pdf](http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/w13-1_belsky_0.pdf).

<sup>5</sup> H.R. COMM. ON WAYS AND MEANS, S. COMM. ON FINANCE, & STAFF OF THE JOINT COMM. ON TAXATION, 115TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2016-2020 33 (Comm. Print 2017) [hereinafter 2017 Tax Expenditure

tax expenditure, and nearly triple what Congress budgeted for the U.S. Department of Housing and Urban Development and all of its programs in 2017.<sup>6</sup> The subsidies are premised on the rationale that homeownership is a good investment for homeowners and also creates spillover benefits for those who live around them (what are known as “positive externalities”<sup>7</sup>) because homeowners take better care of their properties and are more invested and involved in their communities.<sup>8</sup> Therefore, it is a choice that ought to be incentivized.

A great deal of criticism has already been directed at the homeowner subsidies for failing to do what they are ostensibly meant to accomplish. A veritable phalanx of economists, policy analysts and academics have dissected and assailed the subsidies, contending that they neither increase the country’s overall homeownership rate nor cause those who are on the fence about or face financial barriers to purchasing a home to do so.<sup>9</sup> Instead, the primary effect of the subsidies appears to be to encourage those higher income households that would already buy homes to buy larger and more expensive ones.<sup>10</sup> Perversely, they may even drive up home prices in those supply-limited housing markets where home affordability is most problematic.<sup>11</sup> These outcomes are due to some serious design defects in the subsidies and have led to a groundswell of calls for their reform, so that they are better engineered to address the home affordability concerns of prospective low and middle income homebuyers.<sup>12</sup>

As this article will contend, the homeowner subsidies are problematic in another way that has attracted much less attention. While homeowner decisions can benefit those other than the homeowner, so too can they impose

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Budget]. It should be clarified that Congressional estimates of forgone revenue, while useful in understanding the costs of the homeowner subsidies, are not identical to the gain to the federal budget that would result if Congress eliminated the subsidies. Taxpayer behavior would change to some extent if the subsidies were no longer available. See, e.g., Jim Saxton, Joint Economic Committee, U.S. Congress, *Tax Expenditures: A Review and Analysis* (August 1999), p. 8. For example, a homeowner might move less frequently if she faced the prospect of capital gains tax on each sale.

<sup>6</sup> DEP’T OF HOUS. AND URB. DEV., PROPOSED 2017 OF U.S. DEP’T OF HOUS. AND URB. DEV. PROPOSED BUDGET, FISCAL YEAR 2017 (2016).

<sup>7</sup> A positive externality occurs when one party’s actions make others better off but the first party is not compensated for these actions. See, e.g., Jonathan Gruber, *Public Finance and Public Policy* (4<sup>th</sup> ed. 2013), p. 128.

<sup>8</sup> See, e.g., Edward L. Glaeser and Jesse M. Shapiro, *The Benefits of the Home Mortgage Interest Deduction*, NBER Working Paper, No 9284, October 2002.

<sup>9</sup> See *infra* Part II.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

costs on others (what are known as “negative externalities”<sup>13</sup>). For example, a steady exodus of upwardly mobile home buyers to more affluent and exclusive communities can decimate the income tax base and property values in less affluent communities, making the marginalized populations who are left behind financially and otherwise much worse off. Demand for homes in newly built residential developments on undeveloped greenspace far away from urban job centers can heighten damage to the environment through increased carbon emissions that accelerate climate change, the loss of natural lands decreasing biodiversity, and watershed destruction, harming both present and future generations.

Just as a housing decision might have positive and negative consequences for others, so are federal policies related to housing concerned with more than simply its availability. To varying degrees and at considerable expense, federal policies act to contain or offset negative housing externalities, especially those that impose significant or concentrated costs on others. These policies are wide-ranging and evolving, and include: (i) ameliorating blight, deterioration and public health threats in disinvested communities, (ii) decreasing economic and racial housing segregation, and (iii) lessening environmental degradation that results from housing choices, while reducing the vulnerability of those who reside in environmental hotspots.<sup>14</sup>

The problem is that the homeowner subsidies are profoundly disconnected from these other policies and the negative housing externalities they seek to contain. The homeowner subsidies are facially neutral with respect to where one lives and in what type of home, rewarding homeownership decisions at large (assuming that a homeowner is affluent enough to benefit from them). So the subsidies do not aid in ameliorating negative housing externalities, each of which bears some relationship to decisions about home location and type. Furthermore, as this article will explain, the subsidies actually encourage to some degree homeowner decisions that exacerbate these externalities.<sup>15</sup> In other words, the government forgoes huge amounts of tax revenue in exchange for housing consumption that, at best, does little to support and, at worst, actually undermines several of its other housing related policies.

Why the disconnect? Homeowner decisions are complex. So is the nation’s housing market, which actually consists of thousands of much smaller local housing markets and submarkets that vary, sometimes dramatically, in their strengths and weaknesses. The homeowner subsidies,

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<sup>13</sup> A negative externality occurs when one party’s actions make others worse off and they are not compensated by the first party. See, e.g., Gruber, *supra* note \_\_ at 124.

<sup>14</sup> See *infra* Part III.

<sup>15</sup> See *infra* Part III.

on the other hand, are simplistic and monolithic. This article offers three explanations for this design: an idealization of homeownership, administrative simplicity and political intransigence.<sup>16</sup> The end result is that the homeowner subsidies have come to operate like entitlements, reserved primarily for higher income homeowners, rather than strategic policy tools capable of advancing multiple housing objectives. Meanwhile, lacking a demand-side supplement capable of meaningfully influencing homeowner behavior, federal policies that are driven by negative housing externalities reflect a half-hearted, crisis management mentality rather than proactively seeking to contain them.

In addition to shining a light on this disconnect, this article explores whether “smarter” homeowner subsidies might be devised to lessen it.<sup>17</sup> Assuming that Congress wants to continue to financially induce American households to own their homes, it seems sensible to ask if it can leverage these inducements to simultaneously encourage homeowner choices that impose fewer costs on others. As a starting point, this article offers a definition of smarter subsidies as those that are more precisely targeted, externality sensitive and capable of adaptation across multiple housing submarkets. It then looks for lessons from the body of public finance research that has emerged from the experience of state and local government in targeting demand-side tax subsidies to influence business and homebuyer decisions that seek to contain similar types of negative externalities.<sup>18</sup> Although success has been mixed and criticism plentiful, this article draws from the research that when these types of subsidies are tailored, limited, variable and complementary they can be successful and impactful.

Based on these qualities, the article identifies and scrutinizes three conceptual legal models for smarter federal homeowner subsidies.<sup>19</sup> These models are: (i) creating a national map of subsidy eligible and ineligible zones based on the relationship between homeowner behavior in those zones and the reduction of negative housing externalities, (ii) offering a collection of a la carte subsidies each rewarding a specific type of homeowner decision and (iii) allocating subsidies on a community-by-community or project-by-project basis to support community housing plans and other public sector programs that address prescribed negative housing externalities. It is important to emphasize that none of these models need work to the exclusion of improving the performance of homeowner subsidies in making homeownership more affordable. Again, the very question this article grapples with is whether it is possible to engineer the subsidies to

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<sup>16</sup> See *infra* Part IV.

<sup>17</sup> See *infra* Part V.

<sup>18</sup> See *infra* Part V(B).

<sup>19</sup> See *infra* Part V(C).

simultaneously accomplish multiple housing policy objectives.

Each of these models has advantages, but presents challenges, not least of which follows from trying to accomplish multiple objectives across thousands of different U.S. housing markets.<sup>20</sup> At the same time, the article calls attention to the recent revolution in the quality, quantity and accessibility of housing market and property specific real estate data, which is fueling a significant uptick in the sophistication of land use planning at the community level. Those advances may be the best reason to think that smarter federal homeowner subsidies are attainable.

This article closes by suggesting a path forward.<sup>21</sup> The federal government should create a HUD-administered pilot program for targeted homeowner grants using the third model, and through it foster community level innovation to identify models that might be replicated throughout the country. Considering the significant political and practical challenges to undertaking immediate and wholesale reform of the current homeowner subsidies, a more gradual, less expensive and pilot-based strategy should also make adoption by Congress more likely.

This article proceeds as follows. Part I provides a short overview of the three principal homeowner subsidies currently in place. Part II summarizes criticism of the subsidies as to the principal rationale for their existence – encouraging and expanding access to homeownership. Part III examines the subsidies through a different lens by identifying the negative housing externalities that other federal housing-related policies seek to combat and the complete disconnect between the subsidies and containing or offsetting these externalities. Part IV introduces the concept of smarter subsidies and explains why the current subsidies miss the mark. Part V explores in depth how smarter homeowner subsidies might be devised. It examines what research has revealed about the effectiveness of selectively available, demand-side subsidies at the state and local levels, how this might be reflected in the design of federal homeowner subsidies, and the recent advances in real estate data and analytics that may make this feasible. It closes with this article’s proposal for a path forward.

## I. THE TAX CODE’S PRINCIPAL HOMEOWNER SUBSIDIES

This article focuses on the three principal tax breaks that the federal income tax code provides directly to homeowners – the mortgage interest deduction, the property tax deduction and the exclusion from taxable income of capital gain on home sales. The tax code contains other subsidies for homeowners, but none are nearly as expensive nor as broadly utilized as these

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<sup>20</sup> See *infra* Part V(D).

<sup>21</sup> See *infra* Part V(E).

three.<sup>22</sup> For ease of reference, this article uses the term “homeowner subsidies” to mean just these three subsidies.

It is worth noting that the U.S. income tax system provides homeowners a fourth substantial tax break by not taxing the imputed net rental income that results from them living in their own homes. Because the notion of taxing imputed home rental income is viewed as administratively difficult, as well as inconsistent with the how tax code treats other imputed rental income, this article does not include it.<sup>23</sup>

As background, below are basic overviews of the three principal subsidies:

#### A. *The Mortgage Interest Deduction*

Generally speaking, Section 163(h)(2)(D) of the Internal Revenue Code (the “Code”) allows homeowners to deduct the interest they pay on their home mortgages from taxable income.<sup>24</sup> The mortgage interest deduction (the “MID”) is an exception to the general rule that taxpayers may not deduct interest on personal debt (i.e. debt not attributable to a trade or business, or investment activity).<sup>25</sup> It is the largest of the homeowner subsidies. Congress estimates that the MID alone will cost the federal government \$63.6 billion in forgone tax revenue in 2017.<sup>26</sup>

As with most deductions, the MID is subject to numerous statutory clarifications. Most of these are included in the definition of “qualified residence interest,” which provides the actual parameters on what is deductible.<sup>27</sup> Qualified residence interest includes interest on debt up to \$1,000,000 that is secured by a qualified residence and that is used to acquire, construct or substantially improve the residence (“acquisition indebtedness”).<sup>28</sup> It also includes interest on up to \$100,000 in “home equity indebtedness,” which is debt secured by a qualified residence and used for

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<sup>22</sup> See Benjamin H. Harris, C. Eugene Steuerle, & Amanda Eng, *New Perspectives on Homeownership Tax Incentives*, 141 TAX NOTES 1315, 1317 (2013) (identifying the cost of the three principal homeowner tax incentives in 2013 as \$121.3 billion as compared to \$7.8 billion for the cost of the Code’s eight other housing related tax expenditures). Examples of other tax code homeowner subsidies include the deduction for premiums for qualified mortgage insurance and the exclusion of income attributable to the discharge of principal residence acquisition indebtedness.

<sup>23</sup> See Steve R. Johnson, *Imputed Rental Income: Reality Trumps Theory*, in *CONTROVERSIES IN TAX LAW: A MATTER OF PERSPECTIVE*, (Anthony C. Infanti eds., 2015).

<sup>24</sup> 26 U.S.C. § 163(h)(2)(D) (2017).

<sup>25</sup> 26 U.S.C. § 163(h) (2017).

<sup>26</sup> 2017 Tax Expenditure Budget, *supra* note \_\_\_, at 32.

<sup>27</sup> 26 U.S.C. § 163(h)(3) (2017).

<sup>28</sup> § 163(h)(3)(B)(ii) (2017). The limitation if the taxpayer is a married individual filing a separate return is \$500,000.

any other purpose.<sup>29</sup> “Qualified residence” means the taxpayer’s principal residence, as well as up to one additional home the taxpayer uses as a residence (e.g. a vacation or weekend home).<sup>30</sup>

An important feature of the mortgage interest deduction is that it is an itemized deduction.<sup>31</sup> This imposes some very significant limitations on who can claim it. First, in order to take any deduction, a person must have taxable income from which to subtract the deduction.<sup>32</sup> Many U.S. households fall below the income thresholds for paying any federal income tax and, thus, cannot utilize the MID.<sup>33</sup> Second, because the Code automatically provides all taxpayers with a standard deduction that can be taken in lieu of itemized deductions, an itemized deduction is only worthwhile to those taxpayers whose total itemized deductions exceed their standard deduction.<sup>34</sup> For that reason, only about 30% of taxpayers itemize, most of whom are in the top income brackets.<sup>35</sup>

At the very high end of the income spectrum, the total amount of itemized deductions a taxpayer can claim is gradually reduced pursuant to what is commonly known as the Pease limitation.<sup>36</sup> The likelihood of the Pease limitation making the mortgage interest deduction entirely worthless, however, is virtually non-existent for all but the very richest of itemizers who would seek to claim it.<sup>37</sup>

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<sup>29</sup> *Id.* Additional limitations apply to the definition of home equity indebtedness. It cannot exceed the difference between the fair market value of the home minus the acquisition indebtedness on the home, 26 U.S.C. § 163(h)(3)(C)(i) (2017). In the case of a separate return filed by a married individual, the limitation on home equity indebtedness for which interest is deductible is \$50,000, 26 U.S.C. § 163(h)(3)(C)(ii) (2017).

<sup>30</sup> 26 U.S.C. § 163(h)(4)(A) (2017).

<sup>31</sup> 26 U.S.C. § 63(d) (2017).

<sup>32</sup> 26 U.S.C. § 63(a) (2017).

<sup>33</sup> Approximately 43% of the population, many of whom are lower income, do not owe any federal income taxes. Robertson Williams, *Who Doesn’t Pay Federal Taxes?*, TAX POL’Y CENT. (Aug. 29, 2013), <http://www.taxpolicycenter.org/resources/video-who-doesnt-pay-federal-taxes>.

<sup>34</sup> 26 U.S.C. § 63(c) (2017).

<sup>35</sup> Sean Lowry, Cong. Research Servs., *Itemized Tax Deductions for Individuals: Data Analysis 2* (2014).

<sup>36</sup> 26 U.S.C. § 68 (2017).

<sup>37</sup> For fiscal year 2016, the Pease limitation only applied to taxpayers with an adjusted gross income (AGI) of more than \$311,300, if married filing jointly, or \$259,400, if single (the “baseline”), *Limit on Itemized Deductions* IN TAX GUIDE 2016, 205 (2016). Most taxpayers affected by the Pease limitation see their itemized deductions reduced by 3% of the difference between the taxpayer’s adjusted gross income and this baseline, 26 U.S.C.S. § 68(a)(1) (2017).

### B. *The Property Tax Deduction*

The Code also allows homeowners to deduct property taxes assessed on their homes from taxable income. The real property tax deduction is part of a broader deduction the Code allows for most taxes a taxpayer pays to state and local governments, which this article will refer to by its commonly known acronym “SALT” (deduction for **S**tate and **L**ocal **T**axes).<sup>38</sup> Congress estimates that the real property tax component of SALT will cost the federal government \$33.3 billion in foregone tax revenue in 2017.<sup>39</sup>

Carved out of SALT are taxes assessed against a particular property for a benefit understood to increase that property’s value, like the installation of a sidewalk or an irrigation system on that property.<sup>40</sup> But, so long as the real property tax is levied for the general public welfare, the taxpayer may deduct it.<sup>41</sup>

As with the mortgage interest deduction, SALT is an itemized deduction, and thus only claimed by those who have federal taxable income and also have enough qualifying expenses to make itemizing deductions worthwhile.<sup>42</sup> SALT may also be reduced for high income taxpayers by the Pease limitation, though as with the MID this is only even potentially an issue for very high income households.<sup>43</sup>

SALT is potentially reducible in another way, which, for the most part, does not apply to the MID.<sup>44</sup> SALT is added back into taxable income when a taxpayer is subject to the Code’s alternative minimum tax (“AMT”).<sup>45</sup> The AMT is a parallel income tax system that applies an alternative tax rate to a broader base of income of a wealthier taxpayer whose taxable income under the normal rules has been so reduced by exemptions and deductions that her effective tax rates has reached an unacceptable level.<sup>46</sup> About 5% of taxpayers are subject to the AMT<sup>47</sup> and it is good bet that many of them

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<sup>38</sup> 26 U.S.C.S. § 164 (2017); 26 U.S.C. § 164(a) (2017) (identifying “state and local, and foreign, real property taxes” as includable within the deduction).

<sup>39</sup> 2017 Tax Expenditure Budget, *supra* note \_\_, at 32.

<sup>40</sup> 26 U.S.C. § 164(c)(1) (2017); 26 C.F.R. 1-164-4(a).

<sup>41</sup> 26 C.F.R. 1-164-3(b).

<sup>42</sup> 26 U.S.C. § 63(d) (2017).

<sup>43</sup> *Supra* note \_\_.

<sup>44</sup> The alternative minimum tax does not apply to amounts deducted as acquisition indebtedness, which is the more substantial component of the MID, 26 U.S.C. § 56(e) (2017). Interest on home equity indebtedness is however added back in to taxable income when calculating the AMT.

<sup>45</sup> 26 U.S.C. § 55 (2017).

<sup>46</sup> NORTON FRANCIS ET AL., *State and Local Taxes* IN TAX POL’Y CENT. BRIEFING BOOK (Peter Passell et al. 2016) (ebook), <http://www.taxpolicycenter.org/briefing-book/how-does-deduction-state-and-local-taxes-work>.

<sup>47</sup> *Characteristics of Alternative Minimum Tax (AMP) Payers, 2016 – 2018 and 2027*,

see the value of SALT reduced.<sup>48</sup> Nevertheless, this is far less than the total percentage of taxpayers claiming SALT, which is virtually all itemizers.<sup>49</sup>

### C. *The Exclusion of Capital Gain on Home Sales*

Section 121 of the Code also allows homeowners to exclude from federal income tax up to \$250,000 (or \$500,000 if married filing jointly) of the gain they realize when selling their principal residences.<sup>50</sup> Forgoing tax on this income will cost the federal government an estimated \$32.1 billion in 2017.<sup>51</sup>

Certain qualifications apply, of course. A taxpayer can use this exclusion no more than once every two years.<sup>52</sup> Also, the taxpayer must have used the home in question as her principal residence for at least two of the five years prior to sale, a requirement that leads to several statutory permutations to address circumstances like subsequent marriages, spouses residing in separate homes, time spent in uniformed services, etc.<sup>53</sup>

As an exclusion from income rather than a deduction, it applies more broadly than a deduction. Most home sellers benefit from it. This is because the gain, subject to the monetary limits identified above, is not calculated as part of taxable income in the first place, and therefore is not subject to the limitations imposed on itemized deductions. For the same reason, it is not subject to offset by the Pease limitation or the AMT.

## II. RELATIONSHIP OF SUBSIDIES TO ENCOURAGING AND EXPANDING ACCESS TO HOMEOWNERSHIP

Judging by their origins, the homeowner subsidies are a motley crew. The mortgage interest deduction originates from a provision in the nation's original income tax code that at one time made interest on all personal debt deductible.<sup>54</sup> The property tax deduction is part of the broader deduction for

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TAX POL'Y CENT. (Apr. 28, 2017), <http://www.taxpolicycenter.org/model-estimates/baseline-alternative-minimum-tax-amt-tables-april-2017/t17-0149-characteristics>.

<sup>48</sup> FRANCIS, *supra* at note \_\_\_\_.

<sup>49</sup> See Congressional Budget Office, THE DEDUCTIBILITY OF STATE AND LOCAL TAXES (February 2008).

<sup>50</sup> 26 U.S.C. § 121 (2017).

<sup>51</sup> 2017 Tax Expenditure Budget, *supra* note \_\_\_\_, at 32.

<sup>52</sup> 26 U.S.C. § 121(b)(3) (2017).

<sup>53</sup> 26 U.S.C. § 121 (2017).

<sup>54</sup> This may have resulted from Congress wishing to save taxpayers from what was then perceived as the difficult task of distinguishing between personal and profit-seeking debt. See generally Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 LAW & CONTEMP. PROBS. 233 (2010).

most state and local taxes, which is available to homeowners and non-homeowners alike and is arguably separately justified as shielding taxpayers from the inequity of paying income tax on dollars they must pay in taxes.<sup>55</sup> Even the exclusion of home sale capital gains did not originate in a singular pronouncement to incentivize homeownership. Rather, it came about piecemeal, through gradual accretion to the notion that gains realized on the sale of one's home can bring about large, untimely and administratively challenging tax burdens, and that trying to relieve this tax only in certain circumstances causes distortions in the behavior of other homeowners and creates inequities.<sup>56</sup>

Origins notwithstanding, all three subsidies are now commonly justified as encouraging homeownership. The mortgage interest deduction survived the 1986 overhaul of the Code, when Congress repealed the rest of the personal debt interest deduction, because proponents spun it as essential to preserving the American Dream of homeownership.<sup>57</sup> SALT has been the object of multiple unsuccessful repeal efforts, and in each case Congress has considered carving out the property tax deduction component in recognition of its link to homeownership.<sup>58</sup> And the periodic expansions of the home sale capital gains exclusion clearly would not have been possible without the understanding that homeownership, as a form of saving and investment, was something Congress sought to promote. Year after year, Congress reports all three subsidies as housing expenditures, making no secret of what it believes they are meant to do.<sup>59</sup>

There is some irony then in the significant doubt cast on the link between the homeowner subsidies and encouraging or expanding access to homeownership. The MID, perhaps because it is the largest, has received the greatest scrutiny. Most strikingly, several policy experts have proclaimed that the MID has no discernible effect on the homeownership rate.<sup>60</sup> Viewed

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<sup>55</sup> MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 410 (Foundation, 7th ed. 2013).

<sup>56</sup> See generally Lily Kahng, *Path Dependence in Tax Subsidies for Home Sales*, 65 ALA. L. REV. 187 (2013).

<sup>57</sup> See Ventry, *supra* note \_\_\_\_.

<sup>58</sup> Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2116. See, also, <http://www.politico.com/story/2017/09/28/gop-tax-reform-feud-state-local-tax-break-243285>.

<sup>59</sup> See 2017 Tax Expenditure Budget, *supra* note \_\_\_\_.

<sup>60</sup> See, e.g., Edward L. Glaeser & Jessie M. Shapiro, *The Benefits of the Home Mortgage Interest Deduction*, 3 (Nat'l Bureau of Econ. Research, Working Paper No. 9284 2002); Christian A. L. Hilber & Tracy M. Turner, *The Mortgage Interest Deduction and Its Impact on Homeownership Decisions*, 96 Rev. of Econ. and Stat. 618 (2013). Jonathan Gruber, Amalie Jensen and Henrik Kleven, *DO PEOPLE RESPOND TO THE MORTGAGE INTEREST DEDUCTION? QUASI-EXPERIMENTAL EVIDENCE FROM DENMARK*, Working Paper 23600, <http://www.nber.org/papers/w23600> (July 2017).

over a half century, the American homeownership rate has remained relatively constant, even though the value of the MID has fluctuated significantly at times, suggesting that an increased level of MID subsidy doesn't cause a greater percentage of Americans to become homeowners.<sup>61</sup>

This is not to say that the MID has no impact on home-buying decisions. In fact, numerous studies have shown that the MID does increase the amount Americans spend on housing.<sup>62</sup> But its primary impact is on high-income households who increase their housing consumption by buying larger and more expensive homes than they otherwise might.<sup>63</sup> These are households that would likely already buy and thus don't need subsidies to encourage them to do so.<sup>64</sup> Low and middle income households, which are those likely to be on the fence between renting and buying a home, are by comparison largely unimpacted by the MID.<sup>65</sup>

The explanation for why the MID produces these results is no great mystery and has received considerable attention. The MID is a classic example of an upside down subsidy. As discussed in Part I, the only homeowners who can take advantage of the MID are those who have taxable liability to offset and have sufficient qualifying expenses (mortgage interest, income taxes, charitable contributions, etc.) to make itemizing deductions worthwhile, as opposed to taking the standard deduction.<sup>66</sup> These requirements alone make nearly all of the lower two income quintiles of American households ineligible for the MID, and leaves only roughly 30% of taxpayers, primarily those in the upper two income quintiles, as potential claimants.<sup>67</sup>

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<sup>61</sup> Christian A. L. Hilber & Tracy M. Turner, *The Mortgage Interest Deduction and Its Impact on Homeownership Decisions*, 96 Rev. of Econ. and Stat. 618 (2013).

<sup>62</sup> Dean Stansel & Anthony Randazzo, *Unmasking the Mortgage Interest Deduction: Who Benefits and by How Much? 2013 Update*, REASON FOUND. (Dec. 18, 2013) <http://reason.org/news/show/mortgage-interest-deduction-benefit>; Jeremy Horpedahl & Harrison Searles, *The Home Mortgage Interest Deduction*, MERCATUS CENT.: MERCATUS ON POL'Y SERIES (Jan. 8, 2013), <https://www.mercatus.org/publication/home-mortgage-interest-deduction>; Andrew Hanson, *Size of Home, Homeownership and Mortgage Interest Deduction*, 21 J. OF HOUS. ECON. 195 (2012).

<sup>63</sup> Jeremy Horpedahl & Harrison Searles, *The Home Mortgage Interest Deduction*, MERCATUS CENT.: MERCATUS ON POL'Y SERIES (Jan. 8, 2013), <https://www.mercatus.org/publication/home-mortgage-interest-deduction>; Andrew Hanson, *Size of Home, Homeownership and Mortgage Interest Deduction*, 21 J. OF HOUS. ECON. 195 (2012).

<sup>64</sup> *Id.*; See also, ERIC TODER, ET AL., REFORMING THE MORTGAGE INTEREST DEDUCTION (Urb. Inst. et al. 2010), <http://www.urban.org/sites/default/files/publication/28666/412099-reforming-the-mortgage-interest-deduction.pdf>.

<sup>65</sup> *Id.*

<sup>66</sup> Williams, *supra* note \_\_; *Limit on Itemized Deductions* IN TAX GUIDE 2016, 205 (2016).

<sup>67</sup> See Harris, Steuerle & Eng, *supra* note \_\_ at 1318-1319; see also, ERIC J. TODER,

Furthermore, even among claimants, tax-code deductions are significantly more valuable to higher-income taxpayers than they are to middle and lower income taxpayers. This is so in part because a taxpayer's income is not taxed at a uniform rate; but rather at a series of escalating marginal rates that increase as a taxpayer's income increases.<sup>68</sup> The value of a deduction depends on the rate at which the deducted income would have been taxed. To illustrate, a married couple (filing jointly) with \$280,000 in taxable income and \$10,000 in deductible mortgage interest reduces their taxable income to \$270,000, which is income taxed at 33%.<sup>69</sup> Accordingly, they receive a tax reduction of \$3,300. An otherwise identical couple with \$70,000 in taxable income also deducts \$10,000, but gets a tax reduction of only \$1,500 because this income is in the 15% tax bracket.<sup>70</sup> Add to this that higher income households own more expensive homes, and so usually have larger mortgages and more mortgage interest to deduct, and it is little wonder that the lion's share of the benefits from the MID go to high income households.<sup>71</sup>

Although it has received less isolated scrutiny than the MID, the property tax component of SALT has similar consequences.<sup>72</sup> This is because SALT is nearly identical in design to the MID and likewise an upside down subsidy. Unsurprisingly, its benefits also inure disproportionately to those who are highest income and it is much less valuable to homeowners who are lower income.<sup>73</sup>

The exclusion of home sale capital gains is a different animal from the deductions. But the benefits of this subsidy also flow primarily to higher income individuals. First, households in the 15 percent tax bracket and below pay no capital gains tax and, thus, receive no benefit from this subsidy.<sup>74</sup> For those not automatically exempt from this tax, marginal tax brackets play less of a role than with MID and SALT, since most taxpayers pay tax on capital

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BENJAMIN H. HARRIS & KATHERINE LIM, DISTRIBUTIONAL EFFECTS OF TAX EXPENDITURES 9 (Tax Pol'y Cent., Jul. 2009).

<sup>68</sup> See Graetz & Schenk, *supra* note \_\_ at 23-24.

<sup>69</sup> IRS, *Federal Tax Rates, Personal Exemptions, and Standard Deductions*, IRS: US TAX CENT. (last visited Jul 24, 2017), <https://www.irs.com/articles/2016-federal-tax-rates-personal-exemptions-and-standard-deductions>

<sup>70</sup> *Id.*

<sup>71</sup> ERIC J. TODER, BENJAMIN H. HARRIS & KATHERINE LIM, DISTRIBUTIONAL EFFECTS OF TAX EXPENDITURES 9 (Tax Pol'y Cent., Jul. 2009).

<sup>72</sup> *Id.*; see also, Harris, Steuerle & Eng, *supra* note \_\_ at 1319.

<sup>73</sup> Harris, Steuerle & Eng, *supra* note \_\_ at 1319 (including reference to Urban-Brookings Tax Policy Center Microsimulation Model (version 0613-1), Table 1); Toder, Harris, & Lim, *supra* note \_\_\_\_.

<sup>74</sup> See 26 U.S.C. § 1(h) (referring to tax imposed on capital gains); see also, IRS, TAX TOPIC 409: CAPITAL GAINS AND LOSSES (2017), <https://www.irs.gov/taxtopics/tc409.html>.

gains at a rate of 15%.<sup>75</sup> However, those with very high incomes would pay capital gains tax at a 20% rate and so the break is larger at the high end of the income scale.<sup>76</sup> Furthermore, wealthier taxpayers tend to own more expensive homes, which, all other factors equal, generate larger gain.<sup>77</sup> Finally, wealthier homeowners tend to live in more exclusive and wealthier neighborhoods, where home values appreciate at greater rates and so, again, get larger amounts of tax-free gain upon re-sale.<sup>78</sup>

Not only are the homeowner subsidies by design primarily beneficial to upper income households, they may actually inflate home prices, particularly in areas where housing supply is limited, and thus paradoxically reduce home affordability. Several economists have studied whether the MID, in particular, reduces the cost of homeownership for prospective home buyers or is anticipated by the housing market and simply absorbed (“capitalized”) into higher home prices.<sup>79</sup> The answer appears to be that it depends. Where the supply of housing is limited, due to some combination of regulations that hamper construction and geographic factors, and housing demand is high, home prices fully capitalize the subsidy.<sup>80</sup> So the subsidy does not act to lower homeownership costs and instead increases the bar to lower income households entering the market in those places where they most need a subsidy.<sup>81</sup>

In markets with lax land use regulations and/or fewer geographic barriers, and lower demand, the MID is not fully capitalized and does reduce homeownership costs.<sup>82</sup> But, as explained above, even in these areas the MID inures primarily to the benefit of high income households who would likely already purchase a home and, therefore, does not really improve homeownership attainment.<sup>83</sup>

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<sup>75</sup> *Id.*

<sup>76</sup> *Id.* (generally speaking, single taxpayers with taxable income \$415,050 or greater, and married taxpayers filing jointly with taxable income \$466,950 or greater).

<sup>77</sup> See Harris, Steuerle, & Eng, *supra* note \_\_ at 1319.

<sup>78</sup> See, e.g., David Albouy & Mike Zabek, *Housing Inequality*, (Nat’l Bureau of Econ. Research, Working Paper 21916, 2016); see also, Jim Tankersley & Ted Mellnik, *Exclusive Neighborhoods, Exclusive Recovery*, WASH. POST (May 4, 2016), <https://www.washingtonpost.com/graphics/business/wonk/housing/charlotte/>.

<sup>79</sup> See Hilber & Turner, *supra* note \_\_; see also, Joseph Gyourko & Richard Voith, *The Tax Treatment of Housing and its Effects on Bounded and Unbounded Communities* (Fed. Res. Bank of Phila., Working Paper No. 98-23, 1999); DENNIS R. CAPOZZA, RICHARD K. GREEN, & PATRICK H. HENDERSHOTT, *Taxes, Mortgage Borrowing and Residential Land Prices* IN ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 171-98 (Henry J. Aaron & William G. Gale eds., 1996).

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

In sum, as it relates to increasing homeownership opportunities, the track record of the homeowner subsidies is abysmal. It is more accurate to say that the subsidies reward the homeownership investments of certain homeowners, most of whom need no incentive to become homeowners, than to say the subsidies encourage or expand access to homeownership.

### III. RELATIONSHIP OF SUBSIDIES TO NEGATIVE HOUSING EXTERNALITIES AND RELATED POLICIES

The homeowner subsidies are problematic in another way that has drawn significantly less attention. Decisions as to where and in what type of home a household lives have consequences not only for that household, but the surrounding community and society at large. The benefits to and costs on others that result from homeowner decisions can be thought of as a category of “housing externalities.” To some degree and at considerable expense, the federal government intervenes through policies it adopts to contain or offset negative housing externalities, especially those that impose significant or concentrated costs on others.

As this Part will demonstrate, the homeowner subsidies, at best, provide very little support to these other housing related policies. At worst, they actually exacerbate the negative externalities that the policies try to contain. Moreover, in the absence of a demand-side supplement capable of meaningfully encouraging homeowner behavior that reduces negative housing externalities, the policies are not all that effective. This Part identifies several categories of negative housing externalities, the conditions that give rise to them, the federal policies that seek to contain them and their relationship (or, in actuality, the lack thereof) with the current homeowner subsidies.

#### A. *Ameliorating Blight, Deterioration and Public Health Threats in Disinvested Communities*

##### 1. Background

Communities throughout the country grapple with the collateral damage that results from chronic disinvestment. Community disinvestment is a process by which residents, businesses and other financially mobile economic actors extricate themselves from a community they perceive as deteriorating and too risky in which to invest capital, leading to further

decline and, in some cases, large-scale abandonment.<sup>84</sup>

Illustrative of this phenomenon is the now familiar story of Midwestern and Northeastern “legacy” cities. These are places where industry and manufacturing once flourished and supported thriving residential communities.<sup>85</sup> Persistent adverse economic forces subsequently turned the tide in these cities causing the loss of many large employers and good paying jobs, lowering the overall standard of living and stemming population growth.<sup>86</sup> As their economic fortunes turned for the worse, other forms of capital also fled. Highways, readily available mortgages and a quest for greener, roomier and more homogenous communities catalyzed the flight of more affluent residents, often times to newly-created suburbs just beyond the boundaries of legacy cities.<sup>87</sup> As more mobile residents left and new ones have looked elsewhere, stores have shuttered, community institutions like hospitals and schools have closed or consolidated and banks have stopped lending.<sup>88</sup> Compounded over time, these decisions shrink a legacy city’s income base and decrease its property values meaning local government receives less tax revenue and struggles to provide basic services. At the same time, sustaining an economically needier community and aging infrastructure increases the demands on government.

Left unchecked, disinvestment can cause a full-fledged, downward community spiral spurring the remaining mobile capital to leave, overwhelming local resources and accelerating physical deterioration. Those residents who cannot afford to leave are left behind. More recently, older suburbs closest to the urban cores of legacy cities are encountering the next wave of disinvestment as developers and economically mobile homebuyers push out one ring farther to brand new suburbs and exurbs, or selectively repopulate more trendy sections of urban cores.<sup>89</sup>

This pattern of historically short periods of community settlement, expansion and abandonment in legacy cities is only one narrative (albeit a common one) of community disinvestment in the United States. A bird’s eye view of the country reveals the wide-spread prevalence of disinvesting and disinvested communities, often within close proximity of communities that are prospering.<sup>90</sup> By one measurement, 22.1% of U.S. census tracts have

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<sup>84</sup> See, e.g., Arthur J. Naperstek & Dennis Dooley, *Countering Urban Disinvestment through Community-Building Initiatives*, 42 SOC WORK 506 (1997).

<sup>85</sup> See, e.g., ALAN MALLACH & LAVEA BRACHMAN, *REGENERATING AMERICA’S LEGACY CITIES*, Chapter 1 (Lincoln Inst. of Land Pol’y ed., 2013).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> ELIZABETH KNEEBONE & ALAN BERUBE, *CONFRONTING SUBURBAN POVERTY IN AMERICA* 5-9 (Brookings Inst. Press eds. 2014).

<sup>90</sup> See, e.g., *Heat Maps*, TRULIA, [https://www.trulia.com/home\\_prices/](https://www.trulia.com/home_prices/) (last visited July

significantly depressed property values and predominantly low income populations, which are hallmarks of community disinvestment.<sup>91</sup> So-called “middle neighborhoods” constitute another large category of communities that are less distressed at this point, but sit on the precipice of disinvestment due to their increasingly poorer and older populations, and aging housing stock.<sup>92</sup>

The physical condition of housing stock is a particularly visible and jarring manifestation of the consequences and costs of community disinvestment. Disinvested communities must manage increasing stockpiles of outdated, orphaned, devalued and deteriorating homes. Direct costs associated with these properties include increased code enforcement, boarding, property maintenance (grass and trash), fire and police runs, and, ultimately, when they have reached an advanced stage of decay, demolitions.<sup>93</sup> Meanwhile, local government loses property tax revenue necessary to cover the direct costs as these properties deteriorate and lose value, the owners stop paying the taxes altogether and/or the structures on them are demolished.<sup>94</sup> Then, there is the negative spillover effect vacant and deteriorating homes have on the values of surrounding homes, which not only further reduces property tax revenue for the city, but also depletes the wealth of neighbors, sometimes dramatically.<sup>95</sup>

At work is severe market failure. Negative housing externalities push

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28, 2017); *see also*, Albouy & Zabek, *supra* note \_\_; Martin Burch et al., *Housing Prices Still Falling for Working-Class Families*, WALL ST. J. (June 23, 2015), <http://graphics.wsj.com/underwater-homes/> [<http://perma.cc/NM6R-B6KC>]; ECON. INNOVATION GRP., THE 2016 DISTRESSED COMMUNITIES INDEX (2016), <http://eig.org/wp-content/uploads/2016/02/2016>.

<sup>91</sup> Neighborhood Homes Tax Credit materials, [https://www.dropbox.com/s/048w8v0mygpihmt/NHTC\\_Ohio\\_presentation\\_FINAL.pdf?dl=0](https://www.dropbox.com/s/048w8v0mygpihmt/NHTC_Ohio_presentation_FINAL.pdf?dl=0).

<sup>92</sup> See, generally, Paul Brophy (ed.), *On the Edge: America's Middle Neighborhoods* (2016) and, in particular, *Demographics and Characteristics of Middle Neighborhoods in Select Legacy Cities* (Chapter 3 by Ira Goldstein, William Schrecker and Jacob L. Rosch, indicating that between 37 and 51% of residents in sample legacy cities, like Baltimore, Detroit, Milwaukee and Philadelphia, live in middle neighborhoods).

<sup>93</sup> ROBERTA G. GARBER ET AL., \$60 MILLION AND COUNTING: THE COST OF VACANT AND ABANDONED PROPERTIES TO EIGHT OHIO CITIES v (Rebuild Ohio eds., 208).

<sup>94</sup> *Id.* (studying eight Ohio cities, prior to the national foreclosure crisis that drastically increased property vacancy and deterioration in those cities, and “conservatively” estimating the annual costs of vacant and abandoned properties to those cities at \$64 million-- nearly \$15 million in city service costs and over \$49 million from lost tax revenues from demolitions and tax delinquencies).

<sup>95</sup> DAN IMMERGLUCK, THE COST OF VACANT AND BLIGHTED PROPERTIES IN ATLANTA: A CONSERVATIVE ANALYSIS OF SERVICE AND SPILLOVER COSTS (City of Atlanta & Cmty. Progress ed., 2015) (estimating “conservatively” the costs of vacant and blighted properties in Atlanta to city government at between 2.6 million and 5.7 million annually along with a one-time cost to single family property values of \$153 million).

down property values to the point that they can no longer support private investment. Current homeowners hesitate to make improvements to their homes out of a concern they will not recoup these investments. Developers, lenders and prospective home buyers view rehabbing viable homes or demolishing and replacing blighted ones as cost prohibitive or too risky, and so new capital also dries up.<sup>96</sup>

The costs of supporting flailing housing markets typically prove too much for local actors to bear alone and the federal government steps in. In 1965, Congress created a cabinet level agency, the U.S. Department of Housing and Urban Development (HUD), largely as a response to disinvestment in U.S. cities and a heightening concern for those left to live in them.<sup>97</sup> While HUD has overseen an alphabet soup of different programs over a half century, its longest standing and primary program for addressing disinvestment is the Community Development Block Grant (CDBG) program.<sup>98</sup> Via CDBG, HUD annually transfers billions of federal dollars to cities, urban counties and states to spend on shoring up disinvested communities, much of which goes to trying to stabilize and revitalize their housing markets.<sup>99</sup> Eligible expenses include strategic property acquisition, housing construction and rehabilitation, housing code enforcement and community planning.<sup>100</sup>

Ultimately, however, the amount of assistance HUD provides is small compared to the scope of the problem and has been decreasing steadily for decades.<sup>101</sup> Furthermore, CDBG rules effectively restrict funding to areas with high poverty and, thus, already highly distressed housing markets; in so doing, these rules exclude communities that are starting to deteriorate, but

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<sup>96</sup> This latter phenomenon, in which lender are unwilling to lend at the value at which the homeowner assesses the property, is known as the “appraisal gap,” *See, e.g.*, Brena Swanson, *Homeowner Expectations and Appraisal Values Divided as Gap Widens*, HOUSINGWIRE (Mar. 8, 2016), <https://www.housingwire.com/articles/36481-homeowner-expectations-and-appraisal-values-divided-as-gap-widens>.

<sup>97</sup> JILL KHADDURI, *The Founding and Evolution of HUD: 50 Years, 1965–2015* IN HUD AT 50: CREATING PATHWAYS TO OPPORTUNITY 16 (Dep’t of Hous. and Urb. Dev. ed., 2015).

<sup>98</sup> *Id.* at 20; the CDBG program was established by the Housing and Community Development Act of 1974 (P.L. 93-383) and codified, as amended, at 42 U.S.C. 5305.

<sup>99</sup> See generally George Galster, Christopher Walker, Christopher Hayes, Patrick Boxall and Jennifer Johnson, *Measuring the Impact of Community Development Block Grant Spending on Urban Neighborhoods*, *Housing Policy Debate* 15:4, 903-934 (2004).

<sup>100</sup> DEP’T OF HOUS. AND URB. DEV., *Activity Selection and Implementation* IN BASICALLY CDBG FOR ENTITLEMENTS (2014), <https://www.hudexchange.info/resource/19/basically-cdbg-training-guidebook-and-slides/>.

<sup>101</sup> Ira Goldstein, William Schrecker and Jacob L. Rosch, *Demographics and Characteristics of Middle Neighborhoods in Select Legacy Cities*, p. 24 (Chapter 3 from *On the Edge: America’s Middle Neighborhoods*, Paul Brophy ed.) (2016).

where intervention could enable a turnaround.<sup>102</sup> This is emblematic of the crisis-management mentality the federal government takes to disinvestment. This mentality was further exemplified by the Congressional response to communities hit hardest during the country's recent foreclosure crisis, a disinvestment event of mammoth proportions. Congress approved \$7.6 billion in Neighborhood Stabilization Program funds, administered through CDBG, over a five year period to try and stop the most severe bleeding in housing markets afflicted by concentrated numbers of foreclosures and vacancies.<sup>103</sup> But it refused to extend the program beyond this point, even though few of the communities funded had shown signs of a turnaround.<sup>104</sup>

To this point, this section has focused on the housing market dysfunction that follows from community disinvestment, while ignoring the associated human and quality of life costs. These are in fact quite staggering. Older communities with large numbers of distressed and vacant residential properties have remarkably higher incidences of public health issues, like lead paint poisoning among children,<sup>105</sup> asthma,<sup>106</sup> chronic health conditions,<sup>107</sup> and other environmental hazards.<sup>108</sup> They also correlate strongly with higher incidences of violent crime.<sup>109</sup> Local governments rely on a stable residential tax base to fund critical infrastructure like school systems, water line maintenance, sewage and storm water systems, road repair and public

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<sup>102</sup> Penn Institute for Urban Research, University of Pennsylvania, *Retooling HUD for a Catalytic Federal Government*, A Report to Secretary Shaun Donovan, p. 112.

<sup>103</sup> Paul A Joice, *Neighborhood Stabilization Program*, 13 CITYSCAPE: A J. OF POL'Y DEV. AND RES. 135, 135 (2011).

<sup>104</sup> Chaddock, G. R., House looks to cut \$62 billion for distressed homeowners, properties. *Christian Science Monitor* (March 11, 2011). Later efforts to extend and expand the Neighborhood Stabilization Program, via the Project Rebuild Act of 2013, stalled in Congress.

<sup>105</sup> See e.g., *Exploring the Relationship Between Vacant and Distressed Properties and Community Health and Safety*, CENT. ON URB. POVERTY AND CMTY. DEV., AT CASE WESTERN RES. UNIV. (June 7, 2017), <http://cwru.maps.arcgis.com/apps/Cascade/index.html?appid=b1140bfd8484f609ae7c9cb061aa3f4> [hereinafter *Distressed Properties Study*]; *A Hidden Problem: Lead-Poisoned Children in the U.S.*, CALIF. ENVTL. HEALTH TRACKING PROGRAM (Apr. 2017), <http://www.cehtp.org/page/lead/lead-report>.

<sup>106</sup> Jonathan J. Sheffield, *Resident Health and HUD's Choice Neighborhoods Initiative*, 23 J. OF AFFORDABLE HOUSING & CMTY DEV. L. 117, 119 (2014).

<sup>107</sup> Susan J Popkin, *A Glass Half-Empty? New Evidence from the HOPE VI Panel Study*, 20 HOUS. POL'Y DEBATE 43 – 63 (2010).

<sup>108</sup> Benfer, Emily A. and Gold, Allyson E., *There's No Place Like Home: Reshaping Community Interventions and Policies to Eliminate Environmental Hazards and Improve Population Health for Low-Income and Minority Communities* (July 20, 2017). *Harvard Law & Policy Review*, Vol. 11, No. 2, 2017; U of Alabama Legal Studies Research Paper No. 3006099. Available at SSRN: <https://ssrn.com/abstract=3006099>.

<sup>109</sup> *Distressed Properties Study*, *supra* note \_\_; see, also, Erica Raleigh & George Galster, *Neighborhood Disinvestment, Abandonment, and Crime Dynamics*, 37 J. URB. AFF. 397 (2015).

transit. When tax revenue shrinks, all of these suffer.<sup>110</sup>

The federal government routinely directs billions of dollars annually to communities struggling to meet these types of costs through a wide array of programs.<sup>111</sup> Again, it is also the ultimate backstop when a crisis that traces back to disinvestment arises. As simply one example, cost-cutting to meet municipal general fund shortfalls recently resulted in contamination of the water supply of Flint, Michigan, long viewed as a poster child for urban disinvestment. With the city teetering on the brink of bankruptcy, Congress stepped in with \$120 million to help replace lead water supply lines in all of Flint's homes and to make an initial down payment on the long-term health issues expected from the widespread lead poisoning of the city's residents that had occurred.<sup>112</sup>

This is to say nothing of the considerable dollars Congress has spent or forgone in attempts to revitalize disinvested communities through economic development. These initiatives have varied from decade to decade and included Enterprise Zones, Enterprise and Renewal Communities, and New Market Tax Credits.<sup>113</sup> For the most part, they have sought to leverage federal grants and tax breaks to attract private capital to invest in businesses in distressed neighborhoods in order to put local residents to work and spark community reinvestment.<sup>114</sup>

## 2. Relationship to Homeowner Subsidies

As the federal interventions described above suggest, what disinvestment has wrought, the reinvestment of private dollars would help remedy. An influx of new homeowners would reduce stockpiles of vacant structures, invest capital in rehabilitated or new homes, increase tax revenue and, by extension, offset negative housing externalities associated with disinvestment.<sup>115</sup> This has proven to be the case in communities throughout

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<sup>110</sup> Jonathan Masters, *Why the Fiscal Health of States and Cities Matters*, COUNS. ON FOREIGN REL.: RENEWING AM. (Oct. 2, 2012), <https://www.cfr.org/background/why-fiscal-health-states-and-cities-matters>.

<sup>111</sup> Some examples include HUD's Lead-Based Paint Hazard Control Program, the Department of Transportation's Transportation Investment Generating Economic Recovery grant program, and the Department of Education's Title I and Title IV funding for low income school systems.

<sup>112</sup> Todd Spangler, *Congress Approves at Least \$120M for Flint Water Fix*, DETROIT FREE PRESS (Dec. 10, 2016, 8:04 AM), <http://www.freep.com/story/news/local/michigan/flint-water-crisis/2016/12/10/congress-flint-water-funding/95243816/>.

<sup>113</sup> See Chapter 6 and Chapter 9 in *Building Healthy Communities: A Guide to Community Economic Development for Advocates, Lawyers and Policy Makers* (ed. Roger A. Clay, Jr. and Susan R. Jones).

<sup>114</sup> *Id.*

<sup>115</sup> MAUREEN KENNEDY & PAUL LEONARD, *DEALING WITH NEIGHBORHOOD CHANGE: A*

the country where disinvestment wrecked less damage and some combination of market dynamics and forward looking policies created the right mix of circumstances for reinvestment to occur.<sup>116</sup> It is also the philosophy Congress has adhered to in creating federal tax breaks for businesses to locate in disinvested communities.

And yet the homeowner subsidies are, at least on their face, entirely neutral in this regard. They reward an investment in homeownership equally no matter where it occurs, whether it is in a thriving residential market or one that is highly disinvested. The end result is that although the federal government absorbs significant costs in containing damage to and ostensibly laying the foundation for housing market recoveries in disinvested communities, its primary mechanisms for encouraging households to invest in homes do nothing to encourage prospective homebuyers to purchase there.

Furthermore, although facially neutral, the reality is that the subsidies to a large extent support homeowners who live in affluent, non-disinvested communities. Numerous studies have demonstrated that the geographic distribution of the subsidies is strongly tilted towards areas where housing prices, income levels and homeownership rates are high<sup>117</sup> – the hallmarks of a healthy housing market. This is unsurprising considering the design of the subsidies. Home sale gains are more likely to occur (and in greater amounts) in robust housing markets, and, therefore, the savings yielded by excluding them from capital gains tax will also be greater.<sup>118</sup> Also, home prices are higher in stronger housing markets. Those with the most expensive homes not only are likely to have larger mortgages and higher property taxes, but also sit in higher marginal tax brackets and, therefore, receive a greater tax benefit for each dollar of mortgage interest and property tax they deduct.

Conversely, homeowners in disinvested communities will, generally speaking, have lower mortgage interest and property tax costs (due to the lower values of their homes), sit in lower marginal tax brackets, and yield smaller gains upon selling their homes, and, thus, yield less benefit from the homeowner subsidies. An exception to this rule exists for those who own more expensive homes in disinvested communities that have higher local

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PRIMER ON GENTRIFICATION AND POLICY CHOICES, 14 (Brookings Inst. ed., 2001) <https://www.brookings.edu/wp-content/uploads/2016/06/gentrification.pdf>.

<sup>116</sup> *Id.*

<sup>117</sup> See, e.g., Jeremy Ratner, *The Geographic Distribution of the Mortgage Interest Deduction*, PEW CHARITABLE TRUST (Apr. 30, 2013), <http://www.pewtrusts.org/en/research-and-analysis/reports/2013/04/30/the-geographic-distribution-of-the-mortgage-interest-deduction>; Joseph Gyourko & Todd Sinai, *The (Un)Changing Geographical Distribution of Housing Tax Benefits: 1980-2000*, 9 (Nat'l Bureau of Econ. Research, Working Paper No. 10322, 2004).

<sup>118</sup> Thomas Bier, Ivan Maric & Winifred Weizer, *A Preliminary Assessment of the New Home Seller Capital Gains Law*, 11 HOUS. POL'Y DEBATE 645, 645-673 (2000).

property tax rates due to greater municipal costs. In this way, the property tax deduction may alleviate a barrier to homeownership in disinvested communities. But this subsidy is not intentionally designed to achieve this end and so any positive impact it has on housing markets in disinvested communities is largely incidental. The reality is that homes are typically worth less in disinvested communities and fewer residents are affluent enough to itemize their deductions, making the property tax deduction relatively less valuable for homeowners in these communities than in more affluent communities.

The bottom line is that the homeowner subsidies do relatively little to encourage homeowners to invest in disinvested communities. While this again is unsurprising based on how deductions and exclusions operate, it seems difficult to justify a system in which the vast majority of the homeowner subsidies incentivize home purchases in housing markets that function well and in which the private market already rewards homeowners for their purchases, while doing little for struggling markets that present large disincentives to purchase and impose significant costs on the public sector. This is especially true given that, as Part II demonstrated, the subsidies don't even help lower income households access thriving markets and, in fact, probably operate to exclude them.<sup>119</sup>

To go one step further, the homeowner subsidies probably counteract the federal government's policy of containing the damage in disinvested communities by incentivizing higher income taxpayers to leave or stay away. This is because the principal impact of the subsidies is to cause these types of taxpayers to over-invest in housing, by buying larger, more expensive homes than they might otherwise and in higher income areas so that they can maximize their tax benefits under the subsidies.<sup>120</sup> Especially when coupled with exclusionary land use restrictions (like large minimum lot size requirements) imposed in many high-end developments, the subsidies contribute to a form of income level sorting, attracting more affluent prospective homeowners to higher income areas, squeezing out low income entrants and contributing to capital flight and home price losses in declining housing markets.<sup>121</sup>

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<sup>119</sup> See text accompanying footnotes \_\_ through \_\_.

<sup>120</sup> Joseph Gyourko & Richard Voith, *The Price Elasticity of Demand for Residential Lotsize: Estimation and Implications of Tax Code-Related Subsidies on Urban Form*, Univ. of Pa: Wharton Real Estate Cent., (1998); Richard Voith, *Does the Federal Tax Treatment of Housing Affect the Pattern of Metropolitan Development?*, 1999 FED. RES. BANK OF PHILA. 3.

<sup>121</sup> *Id.*

## B. Decreasing Economic and Racial Segregation

### 1. Background

Housing in the United States is highly segregated by wealth and race. Economic segregation, in particular, is increasing dramatically. The percentage of poor households living in high poverty neighborhoods has grown from 43% to 54% in just the last 15 years; meanwhile, the percentage of high income households living in high income neighborhoods has also escalated (from 40% to 49% in the last 25 years).<sup>122</sup> These statistics are consistent with recent studies revealing that high income households are with greater frequency choosing to pay more to live in exclusive communities, and with the decrease in the size of the middle class.<sup>123</sup> This increasing stratification is facilitated by land use restrictions imposed by local ordinances and property developers and market-driven forces that drive up the cost of housing in affluent communities to the point where it effectively bars low income residents.

Racial segregation in housing is actually declining gradually, but remains quite high. A Brookings Institute study based on 2010-2014 census data showed that all 52 of the nation's largest metropolitan areas are significantly segregated by race.<sup>124</sup> This is especially true as it relates to black-white segregation. According to one common measurement of housing segregation, more than half of all blacks would have to move from their current communities to white communities in order for those communities to match the national ratio of white to black residents.<sup>125</sup> Racial segregation is the legacy of a legal system that for much of the country's history permitted discrimination in housing practices and a culture that has long stigmatized differences in race.<sup>126</sup> Race-based neighborhood stereotyping continues to be a common practice and an explanation for why many white homebuyers choose to avoid or leave neighborhoods with large or growing African-

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<sup>122</sup> See JOINT CENT. FOR HOUS. STUD. OF HARV. UNIV. ET AL., *THE STATE OF THE NATION'S HOUSING 2017*, at 17 (2017); see also, Richard Fry & Paul Taylor, *The Rise of Residential Segregation by Income*, PEW RES. CENT.: SOC. AND DEMOGRAPHIC TRENDS (Aug. 1, 2012), <http://www.pewsocialtrends.org/2012/08/01/the-rise-of-residential-segregation-by-income/>.

<sup>123</sup> *Id.*; See also, JOINT CENT. FOR HOUS. STUD. OF HARV. UNIV. ET AL., *THE STATE OF THE NATION'S HOUSING 2016*, at 35 (2016); see also, Albouy & Zabek, *supra* note \_\_\_\_.

<sup>124</sup> William H Frey, *Census Shows Modest Decline in Black- White Segregation*, BROOKINGS INST.: THE AVE. (Dec. 8, 2015), <https://www.brookings.edu/blog/the-avenue/2015/12/08/census-shows-modest-declines-in-black-white-segregation/>.

<sup>125</sup> *Id.* This is called the racial dissimilarity index.

<sup>126</sup> See, generally, RICHARD ROTHSTEIN, *THE COLOR OF LAW: A FORGOTTEN HISTORY OF HOW OUR GOVERNMENT SEGREGATED AMERICA* (Liveright ed., 2017).

American populations.<sup>127</sup>

Because poverty rates are much higher among African Americans and Hispanics than among whites, it is difficult to separate a discussion of economic and race segregation.<sup>128</sup> Low income neighborhoods in the United States have disproportionately high minority populations.<sup>129</sup> In fact, not only poor African-Americans but all African-Americans are much more likely to live in high poverty neighborhoods than their white counterparts.<sup>130</sup> Perhaps most troubling, 66% of young African-Americans live in poor neighborhoods (10 times as many as young whites).<sup>131</sup>

Housing segregation imposes severe costs on those who live in high poverty communities.<sup>132</sup> To a large extent, these communities overlap with the disinvested communities discussed in Part III(A.) and, thus, face many of the same problems. These include smaller tax bases and less private investment, resulting in poorer quality housing, institutions, infrastructure and services for their residents.<sup>133</sup> High poverty communities also fare much worse in terms of safety, environmental quality and health.<sup>134</sup> Part III, A. details these negative externalities and federal involvement in mitigating them.

Particularly germane to residential segregation and worth separate mention here is the opportunity gap, or a lack of access to pathways out of poverty, for those isolated in high poverty communities. These pathways include well-performing schools, positive role models, access to job opportunities and examples of success.<sup>135</sup> Instead of these pathways, residents of communities with concentrated poverty must contend daily with unsafe streets, substandard housing conditions and dysfunctional behavior.<sup>136</sup>

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<sup>127</sup> See, e.g., Ingrid Gould Ellen, *Continuing Isolation: Segregation in America Today* (2008); Maria Krysan, Mick P. Couper, Reynolds Farley and Tyrone Forman, *Does Race Matter in Neighborhood Preferences? Results from a Video Experiment*, *American Journal of Sociology* (2009), 115(2): 527-559.

<sup>128</sup> U.S. CENSUS BUREAU, P60-256(RV), *INCOME AND POVERTY IN THE UNITED STATES 2015 (2016)*, <https://www.census.gov/content/dam/Census/library/publications/2016/demo/p60-256.pdf>.

<sup>129</sup> Kathleen McCormick, *Planning for Social Equity*, *LandLines* (Winter 2017), p. 26.

<sup>130</sup> PATRICK SHARKEY, *STUCK IN PLACE: URBAN NEIGHBORHOODS AND THE END OF PROGRESS TOWARDS RACIAL EQUITY* (Univ. of Chi. Press ed., 2013).

<sup>131</sup> *Id.*

<sup>132</sup> JOINT CENT. FOR HOUS. STUD. AT HARV. UNIV., *supra* note \_\_\_ at 35.

<sup>133</sup> Laura M. Tach, *Diversity, Inequality and Microsegregation: Dynamics of Inclusion and Exclusion in a Racially and Economically Diverse Community*, 16 *Cityscape* 13 (2014).

<sup>134</sup> See, e.g., Robert Wood Johnson Foundation, *Commission to Build a Healthier America, Where We Live Matters for Our Health: Neighborhoods and Health* (September 2008).

<sup>135</sup> SHARKEY, *supra* note \_\_\_.

<sup>136</sup> See, e.g., JAMES H. CARR & NADINEE K. KUTTY, *The New Imperative for Equality, IN SEGREGATION: THE RISING COSTS FOR AMERICA 2* (James H. Carr & Nadinee K. Kutty

Of foremost concern is the individual personal harm that follows. However, it is also important to recognize the resulting societal costs that compound over time. These include an increased reliance on entitlement programs and high incarceration rates among residents in these communities, which imposes costs on all taxpayers.<sup>137</sup> On a macro level, high levels of residential isolation inhibit local labor markets stunting a metropolitan area's economic growth and harming both marginalized and non-marginalized residents.<sup>138</sup> Spread across multiple metropolitan areas, it impairs the country's ability to compete in a global economy.<sup>139</sup>

As mentioned previously, explaining the costs of racial segregation, separate from economic segregation, is more challenging. And yet solid evidence exists. For instance, it has long been established that home prices and appreciation in predominantly African American communities lag considerably behind homes in predominantly white communities with comparable resident income levels.<sup>140</sup> This disparity increases with increasing levels of segregation.<sup>141</sup> Lower home appreciation impairs wealth accumulation among African Americans, and the significance of this is magnified because the home is more likely to be the primary financial asset of an African American household.<sup>142</sup> The ripple effect of lower property values also manifests in less local tax revenue which negatively impacts school funding, educational achievement and the delivery of public services in these communities, which in turn contributes to negative racial stereotypes and social polarization. A recent analysis of metropolitan regions across the country demonstrated that a high level of racial segregation causes a much lower per capita income for African Americans and estimated the cost to the Chicago region alone at an estimated \$4.4 billion in annual regional income and more than \$8 billion in annual gross domestic product.<sup>143</sup>

All of this said, federal policy on housing segregation has a

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eds., 2008).

<sup>137</sup> *Id.*

<sup>138</sup> Huiping Li, Harrison Campbell and Steven Fernandez, Residential Segregation, Spatial Mismatch and Economic Growth across US Metropolitan Areas, 50 *Urban Studies* 2642 (2013).

<sup>139</sup> CARR & KUTTY, *supra* note \_\_\_\_.

<sup>140</sup> See, e.g., Gregory D. Squires, *Demobilization of the Individualistic Bias: Housing Market Discrimination as a Contributor to Labor Market and Economic Inequality*, 609 *ANNALS OF THE AM. ACAD. OF POL. AND SOC. SCI.* 200 (2007). See also, David Rusk, "The Segregation Tax: The Cost of Racial Segregation to Black Homeowners," Brookings Institution (2001).

<sup>141</sup> *Id.*

<sup>142</sup> Rebecca Tibbett et al., Ctr. for Global Policy Sols., *Beyond Broke: Why Closing the Racial Wealth Gap is a Priority for National Economic Security* 4 (2014).

<sup>143</sup> Gregory Acs, Rolf Pendall, Mark Trekson and Amy Khare, *The Cost of Segregation, National Trends and the Case of Chicago, 1990-2010* (March 2017).

complicated history. Racial discrimination was at one point the law of the land. Through at least the mid-20<sup>th</sup> century, federal agencies adhered to explicitly segregationist practices that have left an enduring mark on contemporary housing patterns.<sup>144</sup> These included, perhaps most notoriously, the Federal Housing Administration's mortgage underwriting standards, which prevented African American homeowners from getting mortgages to live in white communities, and vice versa.<sup>145</sup> These expressly racially discriminatory policies and practices are fortunately now a relic of the past. Yet, federal agencies to this day face criticism that they do not do enough to address less overt forms of socioeconomic and racial discrimination in housing programs they design.<sup>146</sup>

The passage of the Fair Housing Act by Congress in 1968 was a monumental turning point, at least as it relates to express racial discrimination. The Act prohibited discrimination in any housing transaction based on race and charged HUD with enforcing the Act.<sup>147</sup> Of course, prohibiting discrimination and decreasing segregation are two different matters. The Act also obligated the HUD Secretary (in addition to all federal executive agencies and programs related to housing and urban development) to implement programs not just to prevent discrimination against protected classes, but also to "affirmatively further" fair housing.<sup>148</sup> This mandate has proven more elusive. Its meaning, as well as how vigorously HUD has pursued it, has varied in the years since the Act's enactment, based in part on who has occupied the White House and Congress at the time and the level of opposition mounted by private interests regulated by it.<sup>149</sup>

Nevertheless, HUD has by and large embraced the mantle of fostering more economically and racially inclusive communities as a fundamental part of its mission, especially in recent decades. This goal consistently appears as

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<sup>144</sup> See, generally, ROTHSTEIN, *THE COLOR OF LAW*, supra note \_\_.

<sup>145</sup> *Id.* Other practices included the Public Works Administration's construction of racially designated public housing projects in neighborhoods with matching racial compositions and the federal courts reluctance to step in sooner to disallow private land covenants that prohibited home sales to groups of certain racial, religious and ethnic groups.

<sup>146</sup> For example, federal law allows private landlords to refuse to accept tenants who would pay rent with Section 8 housing vouchers, notwithstanding fairly clear evidence that this is a thinly veiled form of discrimination against the poor and largely minority population of voucher holders. See Evan F. Anderson, *Vouching for Landlords: Withdrawing from the Section 8 Housing Choice Voucher Program and Resulting Disparate Impact Claims*, 78 U. Cin. L. Rev. 371 (2009).

<sup>147</sup> Title VIII of the Civil Rights Act of 1968 (Fair Housing Act), 42 U.S.C. §3601, et seq. (2017).

<sup>148</sup> See 42 U.S.C. §3608 (charging agencies with the duty to affirmatively further the Fair Housing Act's purposes) and 42 U.S.C. 3601 (formally stating, in the Act's preamble, that it is the policy of the United States to provide for fair housing).

<sup>149</sup> JILL KHADDURI, supra note \_\_, 1-101.

a critical plank in HUD's mission statements and strategic plans.<sup>150</sup> Moreover, HUD and Congress have adopted some significant programs aimed squarely at encouraging integration. Perhaps the longest standing pro-integrationist program is the Section 8 rental housing voucher program which, at least in theory, enables low income voucher recipients to move outside their current neighborhoods to find housing. In 1992, Congress authorized the HOPE VI program, a multi-billion dollar, two decade long initiative intended to deconcentrate poverty in public housing projects by demolishing and replacing many of them with mixed income developments.<sup>151</sup> Perhaps the most dramatic strides towards decreasing residential segregation were made during the Obama administration. During this time, HUD enlivened the long-standing obligation that all recipients of HUD funding (which includes many state and municipal governments) regularly assess the state of fair housing within their jurisdictions and report to HUD on their efforts and plans to further it as a condition of continued funding.<sup>152</sup> The Obama administration also introduced a new approach to rental formulas for the Section 8 program aimed at increasing options for voucher holders in more affluent neighborhoods.<sup>153</sup>

## 2. Relationship to Homeowner Subsidies

Homeowner subsidies would seem to be a potentially powerful mechanism for alleviating housing segregation. To the extent that traditional biases or development financing concerns stand in the way of affluent and racially homogenous communities accommodating mixed income housing, the carrot of homeowner subsidies could serve as meaningful leverage for these communities to decide to become more inclusive. Subsidies might also serve as tempting incentives to draw more affluent homeowners to less affluent communities, or to attract homeowners to a racially homogenous community that would improve its diversity. Poorer and racially

<sup>150</sup> See, e.g., Mission Statement, DEP'T OF HOUS. AND URB. DEV. (last visited Jul. 30, 2017), <https://portal.hud.gov/hudportal/HUD?src=/about/mission>; DEP'T OF HOUS. AND URB. DEV., STRATEGIC PLAN 2014-2018 (2014), [https://portal.hud.gov/hudportal/HUD?src=/program\\_offices/spm/strategicplan2014\\_2018](https://portal.hud.gov/hudportal/HUD?src=/program_offices/spm/strategicplan2014_2018).

<sup>151</sup> Susan J. Popkin, Bruce Katz, Mary K. Cunningham, Karen D. Brown, Jeremy Gustafson, and Margery A. Turner, A DECADE OF HOPE VI: Research Findings and Policy Challenges (2004), p. 14.

<sup>152</sup> Department of Housing and Urban Development, Final Rule, Affirmatively Furthering Fair Housing, [https://www.huduser.gov/portal/sites/default/files/pdf/AFFH\\_Final\\_Rule.pdf](https://www.huduser.gov/portal/sites/default/files/pdf/AFFH_Final_Rule.pdf).

<sup>153</sup> See HUD Press Release No. 16-173 (November 15, 2016), [https://www.hud.gov/press/press\\_releases\\_media\\_advisories/2016/HUDNo\\_16-173](https://www.hud.gov/press/press_releases_media_advisories/2016/HUDNo_16-173), announcing Small Area Fair Market Rent approach. The Trump Administration has since suspended this approach for the next two years.

marginalized communities would, in turn, presumably stand to benefit from increased tax bases, improved public services, a decrease in negative stereotypes and an overall reduction of the negative externalities that follow from concentrated economic and racial isolation.

As designed, however, the current homeowner subsidies do very little to support residential integration. Not only are they facially neutral as to where a homeowner purchases, but also as to a prospective homeowner's race, ethnicity and, at least in theory, income level. Thus, the subsidies do not explicitly reward or penalize a homeownership decision that promotes integration or enhances segregation.

Once again, the subsidies are also not actually all that neutral in terms of their impact. Because by design they inure primarily to the benefit of high income homeowners, who are typically found in affluent communities with high home prices, they by and large supplement spending on homeownership in communities that are inaccessible to lower income households (and by extension to the strong majority of minority households as well). Conversely, they are not of much value to those lower income (and oftentimes minority) households who wish to move from opportunity poor to opportunity rich communities.<sup>154</sup>

Stacked on top of this reality is the recognition that the subsidies encourage the type of income sorting discussed in Part III, A., by which affluent homebuyers seek to live in higher yield, higher cost communities to maximize their tax benefits from the subsidies.<sup>155</sup> Accordingly, the subsidies probably serve to increase economic segregation. The one exception, as described in Part III, A., is the property tax deduction, which helps alleviate a barrier to living in communities that have higher taxes due to the greater public expenses that follow from serving lower income populations in poorer cities.<sup>156</sup> However, any positive benefit that follows from this deduction is largely incidental and not a reflection of its design.<sup>157</sup>

The homeowner subsidies probably heighten racial segregation for the same reasons they heighten economic segregation and another more race specific reason as well. As noted earlier, homes in majority African American neighborhoods do not appreciate as much as homes in predominantly white

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<sup>154</sup> See, e.g., Jeremy Ratner, *The Geographic Distribution of the Mortgage Interest Deduction*, PEW CHARITABLE TRUST (Apr. 30, 2013), <http://www.pewtrusts.org/en/research-and-analysis/reports/2013/04/30/the-geographic-distribution-of-the-mortgage-interest-deduction>; Joseph Gyourko & Todd Sinai, *The (Un)Changing Geographical Distribution of Housing Tax Benefits: 1980-2000*, 9 (Nat'l Bureau of Econ. Research, Working Paper No. 10322, 2004).

<sup>155</sup> See text accompanying footnotes \_\_ through \_\_.

<sup>156</sup> See text accompanying footnotes \_\_ through \_\_.

<sup>157</sup> *Id.*

neighborhoods.<sup>158</sup> White prospective home buyers recognize this and factor it into their choice of neighborhood.<sup>159</sup> From this, it is not difficult to extrapolate that many white prospective homeowners view predominantly African American neighborhoods or neighborhoods with growing black populations as bad places to maximize their homeowner subsidies and avoid them.

*C. Lessening Environmental Degradation Resulting from Housing Choices, While Reducing the Vulnerability of Those Who Reside in Environmental Hotspots*

1. Background

A homeowner's decisions as to where to live and in what type of home affects his or her relationship to the natural environment in a wide and complex variety of ways. One example is a home's carbon footprint. Homes are a major source of carbon dioxide (and other greenhouse gas) emissions, and greenhouse gas emissions are the principal cause of global warming.<sup>160</sup> A home built with energy efficient materials, that is smaller, uses renewable energy and requires less driving to get to and from a job center has a smaller carbon footprint and thus harms the environment less, all other things being equal, than one that does not use these materials, is larger, burns fossil fuels and is further away. Some other examples of environmental conditions impacted by housing choices include wetlands protection, habitat and wildlife preservation, fresh and groundwater supply, and storm and sewer water management.

Not only does housing impact the environment, the environment impacts housing. Homes built along coasts and in floodplains are more susceptible to damage by severe weather events and rising tides.<sup>161</sup> Likewise, homes near fault lines, mountains and forests are more susceptible to damage from earthquakes, landslides and forest fires, respectively.

Furthermore, housing can impact the environment in ways that in turn

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<sup>158</sup> *Supra* note \_\_. See also, Dorothy Brown, How Home Ownership Keeps Blacks Poorer Than Whites, *Forbes.com* (December 10, 2012).

<sup>159</sup> Squires, *supra* note \_\_; Ellen, *supra* note \_\_.

<sup>160</sup> Residential heating, cooling and electrical consumption alone accounted for 17% of all greenhouse gas emissions in the U.S. Transportation accounts for 27% of total emissions, and "household travel" accounts for over 80% of miles traveled on the country's roadways. Alex F. Schwartz, *Housing Policy in the United States* (3<sup>rd</sup> edition), p. 3 (citing to U.S. Environmental Protection Agency, *Inventory of U.S. Greenhouse Gas Emissions and Sinks: 1990-2011*).

<sup>161</sup> Freddie Mac, *Life's a Beach, Insight* (April 26, 2016), [http://www.freddiemac.com/research/insight/20160426\\_lifes\\_a\\_beach.html](http://www.freddiemac.com/research/insight/20160426_lifes_a_beach.html).

increase the vulnerability of that housing. Houston's recent encounter with Hurricane Harvey is a telling example. Long recognized as the epitome of booming development catalyzed by a lack of land use regulation, housing developers in Houston have constructed one low-density, concrete laden subdivision after another on top of former prairie.<sup>162</sup> At the same time, Houston sits close to the Gulf of Mexico exposing it to severe storms and hurricanes, which appear to be occurring with greater frequency due to climate change and rising sea levels.<sup>163</sup> By replacing 65 square miles of freshwater wetlands with impervious surfaces on which water can accumulate, Houston's housing development patterns have made it much more vulnerable to massive flooding.<sup>164</sup> This has occurred three times in just the last three years, most recently and tragically with Hurricane Harvey, which caused flooding that led to a loss of lives, inundated entire neighborhoods and damaged an estimated 200,000 homes.<sup>165</sup>

The negative externalities that follow from human behavior that degrades the environment, including housing choices, are wide-ranging and potentially severe. For example, if greenhouse gas emissions do not slow, global warming is expected to raise temperatures worldwide between 2 and 11.5 degrees Fahrenheit during the 21<sup>st</sup> century.<sup>166</sup> Such an increase is projected to significantly raise sea levels, fully or partially submerge certain coastal cities, kill off 30% of the world species, increase human disease, decrease agricultural productivity and lead to a dramatic increase in severe weather events and a significant impairment of the world population's overall quality of life.<sup>167</sup> Accurately pegging the costs imposed by global warming is a difficult task because it is forward-looking and involves many secondary impacts. Attempts to do so have estimated the price tag to the United States as reaching into the trillions of dollars annually if patterns do not change.<sup>168</sup>

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<sup>162</sup> See, e.g., Douglas Belkin and Shibani Mahtini, In Harvey's Wake, Houston Rethinks Real Estate Development, *Wall Street Journal* (September 11, 2017).

<sup>163</sup> See, e.g., Manny Fernandez and Richard Fasset, A Storm Forces Houston, The Limitless City, to Consider Its Limits, *New York Times* (August 30, 2017).

<sup>164</sup> *Id.*

<sup>165</sup> Tulsi Kamath, "Latest numbers show extent of Harvey damage in Houston and Texas," *Houston Chronicle* (Sept. 6, 2017), <http://www.chron.com/news/houston-weather/hurricaneharvey/article/Latest-numbers-show-extent-of-Harvey-damage-in-12175543.php>.

<sup>166</sup> International Panel on Climate Change, *Climate Change 2007: Impacts, Adaptations and Vulnerability* (2007).

<sup>167</sup> *Id.*

<sup>168</sup> See, e.g., The Center for Integrative Environmental Research (CIER) at the University of Maryland, *The US Economic Impacts of Climate Change and the Costs of Inaction* (October 2007); Frank Ackerman and Elizabeth A. Stanton, *Global Development and Environment Institute and Stockholm Environment Institute-US Center, Tufts University, The Cost of Climate Change: What We'll Pay if Global Warming Continues*

Although the economic, health and social costs may potentially be enormous, many will not manifest for decades. This is part of why federal efforts to significantly scale back U.S. greenhouse gas emissions have not succeeded.<sup>169</sup>

Federal policies related to housing and the environment reflect this lack of traction. A good example is the federal response to suburban sprawl. Sprawl is commonly understood to mean low density, minimally controlled, single use residential development that outpaces population growth, occurs on urban fringes and is accessible almost exclusively by automobile.<sup>170</sup> Evidence has mounted of the many negative environmental externalities resulting from uncontrolled sprawl, including the loss of wetlands, increased storm water run-off, increased carbon consumption and the destruction of wildlife habitats.<sup>171</sup> On the one hand, the federal government recognizes sprawl as a significant problem.<sup>172</sup> Congress has empowered the U.S. Environmental Protection Agency (EPA) to regulate certain aspects of land development particularly critical to managing sprawl like local storm water management and wetlands protection.<sup>173</sup> The EPA, through its Office of Sustainable Communities, encourages local and state planners, through funding and educational resources, to implement “Smart Growth” techniques that minimize negative environmental impacts in constructing new residential communities and re-designing existing ones.<sup>174</sup> Other federal agencies, like HUD, the Department of Transportation and FEMA, have recently forged partnerships with the EPA to coordinate their housing and infrastructure funding to incentivize environmentally sustainable communities.<sup>175</sup>

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Unchecked (May 2008).

<sup>169</sup> Vested business interests, skepticism as to government driven solutions to solve environmental problems, global competitiveness and doubt among a segment of politicians and the population as to the existence of the problems are other reasons.

<sup>170</sup> See, e.g., Lee R Epstein, *Where Yards Are Wide: Have Land Use Planning and Law Gone Astray?*, 21 WM. & MARY ENVTL. L. & POL’Y REV. 345, 349 (1997).

<sup>171</sup> Todd Litman, *Analysis of Public Policies that Unintentionally Encourage and Subsidize Urban Sprawl*, 20-21 (The New Climate Economy, Working Paper Mar. 2015).

<sup>172</sup> See, e.g., The Clinton/Gore Administration: Livable Communities for the 21<sup>st</sup> Century, Remarks as Prepared for Delivery by Vice President Al Gore Livability Announcement (Jan. 11, 1999).

<sup>173</sup> See Environmental Protection Agency, Wetlands Protection and Restoration, <https://www.epa.gov/wetlands>.

<sup>174</sup> See Environmental Protection Agency, Smart Growth, <https://www.epa.gov/smartgrowth/about-smart-growth#environmental>.

<sup>175</sup> See, e.g., Partnership for Sustainable Communities, <https://www.sustainablecommunities.gov/mission/about-us>; MEMORANDUM OF AGREEMENT BETWEEN THE DEPARTMENT OF HOMELAND SECURITY/FEDERAL EMERGENCY MANAGEMENT AGENCY (DHS/FEMA) AND THE U.S. ENVIRONMENTAL PROTECTION AGENCY (EPA), <https://www.epa.gov/>

On the other hand, the federal government leaves individual development decisions in the hands of state and local governments,<sup>176</sup> many of which pay no mind to and lack a significant incentive to adopt Smart Growth principles. The degree of attention environmental sustainability receives has varied based on who leads the relevant federal departments and agencies, which has led to a lack of consistency in policy implementation. Furthermore, many have suggested that long-standing, pro-growth policies of the federal government, like the construction and expansion of federal highways, have been instrumental in encouraging suburban sprawl, a contention that a comprehensive Government Accountability Office study on the topic has contested.<sup>177</sup>

Meanwhile, federal policy has been clearer and more consistent in mitigating the financial risks of those who choose to reside in environmental hot spots. Damages homeowners incur due to severe weather events that occur more frequently in these places become negative housing externalities because of the federal government's long standing policy of providing taxpayer-funded relief. For example, Congress and the executive branch have typically rushed to the aid of coastal areas hit hardest by hurricanes and super storms. This assistance has gone well beyond emergency assistance and included helping these higher risk communities rebuild homes and homeowners recover financial losses due to home damage.<sup>178</sup> The federal price tag for storm recovery packages since Hurricane Katrina in 2004 was \$200 billion, prior to Hurricane Harvey.<sup>179</sup> Estimates of projected damage from Hurricane Harvey alone are in the range of \$180 billion, much of which the federal government will cover.<sup>180</sup> Part of these federal aid packages cover deficits in the National Flood Insurance Program (NFIP), which FEMA operates on an ongoing basis to provide flood insurance for homeowners due to the shortage of private insurance options especially in high flood risk areas. NFIP homeowner insurance premiums historically run far short of homeowner flood claims, resulting in a deficit of between \$16 billion and \$25 billion for years 2002 through 2013, which taxpayers ultimately have had to

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[sites/production/files/2016-08/documents/moa-between-fema-and-epa-signed-8-9-16.pdf](https://www.epa.gov/sites/production/files/2016-08/documents/moa-between-fema-and-epa-signed-8-9-16.pdf) (hereinafter, "EPA-FEMA MOU").

<sup>176</sup> Environmental Protection Agency, About Smart Growth, <https://www.epa.gov/smartgrowth/about-smart-growth>.

<sup>177</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GOA/RCED-99-87, EXTENT OF FEDERAL INFLUENCE ON "URBAN SPRAWL" IS UNCLEAR (1999).

<sup>178</sup> Francis X. McCarthy, *Federal Stafford Act Disaster Assistance: Presidential Declarations, Eligible Activities, and Funding*, RL33053 CONG. RES. SERV. 1 (2011).

<sup>179</sup> Umair Ifran, The Stunning Price Tags for Hurricanes Harvey and Irma, Explained, <https://www.vox.com/explainers/2017/9/18/16314440/disasters-are-getting-more-expensive-harvey-irma-insurance-climate>

<sup>180</sup> Id.

pay.<sup>181</sup> More recently, Congress has simply started buying out homeowners in high risk coastal communities (termed climate change refugees), recognizing that it may be cheaper in the long run to demolish the homes rather than having to continually bail them out. Congress has already allocated \$1 billion in dollars to HUD for home purchase and resettlement programs, and Houston is expected to add to the demand.<sup>182</sup>

## 2. Relationship to Homeowner Subsidies

As just discussed, certain homeowner choices do greater harm to the environment than others, although a significant portion of these negative externalities will be borne by future generations. Also, certain choices place homeowners in more environmentally vulnerable locations, and these costs are incurred more immediately by all taxpayers as a result of federal policies that cover a portion of these risks. The homeowner subsidies could serve as one way to discourage those decisions that impose more of these negative externalities and encourage those that would impose less.

Yet, once again, the homeowner subsidies provide virtually no help. Neutral as they are to location and form, they neither encourage nor discourage a prospective homeowner's decisions to, for example, live in a community that is near or far from an urban center, public transportation or an environmentally sensitive or vulnerable area, even though these decisions vary significantly in the price tag they impose on others. Federal policy focuses more on responding to severe damage that follows from environmental catastrophes, rather than on proactively influencing housing decisions that reduce environmental harm or susceptibility in the first place.

Some would go a step further and argue that the subsidies have encouraged certain negative externality producing choices like suburban sprawl. Across almost all metropolitan areas, the benefits of tax subsidies are claimed with greater frequency by those living in suburban and exurban areas, where lot sizes and home are bigger.<sup>183</sup> Homeowners in these areas utilize the subsidies not as an incentive to purchase a home, but rather as an incentive to purchase a bigger home on a larger lot.<sup>184</sup> Accordingly, these

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<sup>181</sup> *Life's a Beach*, FREDDIE MAC: ECON. AND HOUS. RES. INSIGHT (Apr. 26, 2016), [http://www.freddiemac.com/research/insight/20160426\\_lifes\\_a\\_beach.html](http://www.freddiemac.com/research/insight/20160426_lifes_a_beach.html).

<sup>182</sup> See, e.g., Coral Davenport & Campbell Robertson, *First US Climate Change Refugees Get \$48 M to Leave Sinking Town*, NYTIMES (May 6, 2016), <https://www.nytimes.com/2016/05/03/us/resettling-the-first-american-climate-refugees.html>; see also, Robert Freudenberg et al., Buy-in for Buyouts: Three Flood Prone Communities Opt for Managed Retreat, LAND LINES July 2016, at 27-35.

<sup>183</sup> See, e.g., Andrew Hanson, Ike Brannon & Zackary Hawley, *Rethinking Tax Benefits for Home Owners*, 32 NAT'L AFF. 40, 45 (2014).

<sup>184</sup> *Id.*

studies contend that a primary effect of the subsidies has been the construction of larger, “McMansion” style homes that are an average of 250 to 1000 square feet larger than necessary.<sup>185</sup>

It should be noted that, over the past few decades, federal tax policy has made some inroads in encouraging greater energy efficiency in homes, although they are often marketed primarily as a way to cut consumer energy bills rather than as reducing negative externalities. Congress has passed an array of tax incentives for home-builders, home appliance makers and consumers aimed at spurring the supply of and demand for energy efficient homes and home products.<sup>186</sup> For homeowners, these have taken the form of federal income tax credits for the purchase of energy efficient appliances, certain home improvements that increase energy efficiency and the installation of renewable energy systems.<sup>187</sup> Commitment to the homeowner subsidies has been relatively weak, however. The individual energy tax credits were small and subject to low overall caps raising concerns that they did not act as much of an incentive.<sup>188</sup> Most of the credits recently expired, and there appears to be little political will in Congress to renew them.

#### IV. UNDERSTANDING THE DISCONNECT (HOW AND WHY THE CURRENT HOMEOWNER SUBSIDIES ARE NOT SMART)

As Part III demonstrated, there is a striking disconnect between the homeowner subsidies, and other key federal housing policies and the negative housing externalities they seek to contain. Why? The current subsidies are not smart. This Part explains what “smart” means for purposes of this analysis, as well as how and why the subsidies fail to meet the mark.

##### A. What are “Smart” Subsidies?

When it comes to evaluating policies, rather than people, “smart” has a variety of possible meanings, several of which are relevant here. One use of the word occurs in connection with system changes that deploy resources more strategically to improve performance and reduce inefficiencies and breakdowns associated with their use. “Smart” energy grids, for example, deploy energy based on two-way communications with consumers in order to reduce waste, lower costs and make power outages less likely.<sup>189</sup>

The current homeowner subsidies are inefficient in that they reward

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<sup>185</sup> *Id.*

<sup>186</sup> Steven Nadel, *Energy Efficiency Tax Incentives in the Context of Tax Reform* (2012).

<sup>187</sup> 26 U.S.C. § 25C (2017); 26 U.S.C. § 25D (2017).

<sup>188</sup> Hollick & Sherlock, *supra* note \_\_.

<sup>189</sup> See, e.g., [https://www.smartgrid.gov/the\\_smart\\_grid/smart\\_home.html](https://www.smartgrid.gov/the_smart_grid/smart_home.html).

homeowner decisions at large, and without sensitivity to the negative externalities homeowner decisions impose. As a result, at best, the federal government gets very little bang in containing these externalities for the very significant buck it spends rewarding homeownership.<sup>190</sup> At worst, it must pay to clean up damage resulting from homeowner choices it subsidizes.<sup>191</sup>

“Smart” subsidies would reduce these inefficiencies by targeting financial incentives at homeowner decisions that also offset or reduce negative housing externalities. For example, as explained in Part III, C., homeowner decisions to build new homes in higher risk coastal and floodplain areas can increase federal taxpayer burdens due to the government’s policy of providing disaster relief and increase flooding risk for those who already live in the area. A smarter homeowner subsidy in these areas might be limited to those whose homes are built to maximize storm water absorption and/or minimize the likelihood of flooding damage.<sup>192</sup>

A separate, though not unrelated, use of “smart” is in connection with policies that advance “sustainable development.” Development decisions that are “sustainable” take into account their impact on others, including future generations.<sup>193</sup> The replacement of combined sewer and storm water systems that discharge into fresh water sources during large rainfalls with those that can instead temporarily store this water underground is an example of sustainable development. “Smart” is frequently used synonymously with “sustainable” when referring to places that implement sustainability practices (e.g. “Smart Cities”), especially when those places use advances in information and communications technology to do so.<sup>194</sup>

When used in this way, “smart” has a normative component. Sustainable development has specific environmental, economic and social goals. These include protecting the planet from environmental degradation, conserving natural resources, striving for economic growth that does not heighten socioeconomic segmentation and creating places to live that are inclusive, safe and resilient.<sup>195</sup> The federal housing policies that are the subject of Part III fit comfortably within these goals. So, as with the first meaning of the word discussed above, “smart” in this instance means policies that minimize the negative externalities associated with development. The

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<sup>190</sup> *Supra* Part III.

<sup>191</sup> *Id.*

<sup>192</sup> For example, by elevating a home above street level using a foundation or posts. <https://www.fema.gov/pdf/rebuild/mat/sec5.pdf>.

<sup>193</sup> The most cited to definition of sustainable development in in World Commission on Environment and Development (“Brundtland Report”) (1987).

<sup>194</sup> See, e.g., Vito Albino, Umberto Berardi and Rosa Maria Dangelico, *Smart Cities: Definitions, Dimensions and Performance*.

<sup>195</sup> United Nations, Sustainable Development Goals, <http://www.un.org/sustainabledevelopment/sustainable-development-goals/>.

current homeowner subsidies are not smart because they are completely insensitive to them.

Another definition of “smart” has emerged in the technology field. Smart devices are those that are capable of sensing a particular user’s needs or a change in environment and modifying their performance accordingly.<sup>196</sup> Smart data refers to data that can be analyzed and converted to actionable insights to address a particular problem.<sup>197</sup> The key concepts are individualized, adaptable and actionable.

These concepts are meaningful to crafting effective housing strategies. This is because housing markets are highly localized. The United States consists not of one nor even of fifty housing markets, but rather thousands of highly localized markets that vary significantly in strengths and challenges. For example, high density cities with robust economies have thriving real estate markets by most measures, but grapple with inadequate supply and affordability issues, particularly for low and middle income homeowners.<sup>198</sup> Post-industrial Rust Belt cities have more anemic housing markets, with vast inventories of antiquated or deteriorating vacant homes that deplete surrounding home values and pose public health issues.<sup>199</sup> Certain coastal areas face rising tides and need to re-think how, where and whether housing exists.<sup>200</sup> New growth Southwestern cities face high demand, but limited natural resources to support this demand.<sup>201</sup> Within each of these local housing markets exist even smaller submarkets that reflect different amenities, job access and housing stock, among other factors. This set of examples suggests that smart homeowner subsidies would be perceptive and adaptable enough to address different problems in different places. By this standard too, the current homeowner subsidies are clearly not smart. They are simplistic and monolithic, with no intended sensitivity to the challenges faced by different housing markets and submarkets.

So a definition of smarter homeowner subsidies is emerging. They would be more carefully targeted, aiming to increase the social benefits (or reduce the social costs) that follow from homeowner decisions, and capable of adaptation among and within different housing markets.

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<sup>196</sup> See, e.g., IGI Global, What is Smart Technology?, <https://www.igi-global.com/dictionary/smart-technology/38186>.

<sup>197</sup> Wired, Big Data, Fast Data, Smart Data, <https://www.wired.com/insights/2013/04/big-data-fast-data-smart-data/>.

<sup>198</sup> See Glaeser & Gyourko, *supra* note \_\_\_\_.

<sup>199</sup> See, e.g., Frank Ford, *Is the Cuyahoga County Foreclosure Crisis Over?*, WESTERN RESERVE LAND CONSERVANCY (Mar. 18, 2016), <https://www.wrlandconservancy.org/articles/2016/03/18/is-the-cuyahoga-county-foreclosure-crisis-over>.

<sup>200</sup> *Supra* notes \_\_ & \_\_\_\_, and accompanying text.

<sup>201</sup> *Lincoln Institute and Northern Light Productions, Phoenix: The Urban Desert*, YOUTUBE (Sept. 2, 2007), <https://www.youtube.com/watch?v=y0qOD0l9dbQ> (film).

### *B. Why the Current Homeowner Subsidies Are Not Smart*

Before considering whether and how smarter federal homeowner subsidies are feasible, it is helpful to understand why the current subsidies are designed as they are. This article offers three explanations.

#### 1. Idealization of Homeownership

One explanation is a historic cultural attitude in which the homeowner subsidies are rooted that views all homeownership as “good” (in economist-speak, resulting only in positive internalities and externalities). The federal government has long idealized homeownership as possessing several virtues that have since gained popular acceptance. Perhaps foremost is the view first popularized in the 1920s and 1930s that homeownership promotes good citizenship and stable communities, appealing qualities during the social unrest and political radicalism following from mass urbanization in the early 20<sup>th</sup> century.<sup>202</sup> In the decades that followed, the government saw the expansion of homeownership as the means to address a host of social, economic and political problems, including post-World War II population expansion, slum removal, and racial unrest.<sup>203</sup> Towards the end of the century, in the context of rising home prices and a shift away from New Deal, welfare state policies, politicians cast homeownership as an ideal vehicle for household savings and the accumulation of wealth.<sup>204</sup>

From the perspective of the federal government, then, homeownership has typically been something to promote, rather than regulate. This approach finds support in the U.S. Constitution’s deference to state and local governments on matters of land use and sacrosanct view of private property rights.<sup>205</sup> Congress has occasionally intervened to legislate on certain land use matters, like environmental protection and housing discrimination, when it has determined that relying on more localized levels of governmental to independently regulate will fail to consistently or adequately address significant harm to others.<sup>206</sup> It has also used its tax and spend authority to offer financial incentives to prompt state and local

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<sup>202</sup> See, e.g., Brian McCabe, *Selling the Citizen Homeowner: The Civic Roots of the American Dream* IN NO PLACE LIKE HOME: WEALTH, COMMUNITY, AND THE POLITICS OF HOMEOWNERSHIP, 21-44 (Oxford Press eds., 2016).

<sup>203</sup> *Id.*

<sup>204</sup> *Id.*

<sup>205</sup> See, e.g., John R Nolan, *Historical Overview of the American Land Use System: A Diagnostic Approach to Evaluating Governmental Land Use Control*, 23 PACE ENVTL. L. REV. 821 (2006).

<sup>206</sup> *Id.*

governments to take action that reflects federal concerns.<sup>207</sup> But as it relates to individual homeowners, federal policy has focused more on creating opportunities to own homes, than on trying to meaningfully influence where homeowners live or in what types of homes. The design of the homeowner subsidies reflects this philosophy.

## 2. Administrative Simplicity

Like many adjustments to taxable income, the homeowner subsidies are tax incentives trapped in the bodies of exclusions and deductions from taxable income. Exclusions and deductions are different devices for accomplishing the same task – i.e. removing otherwise taxable dollars from tax.<sup>208</sup> The difference between them is primarily a matter of timing. An exclusion keeps otherwise taxable dollars from entering a taxpayer’s pool of gross income in the first place, while a deduction subtracts them from a taxpayer’s gross income in the process of tabulating her taxable income.

Exclusions and deductions are straightforward, effective and easy to justify mechanisms for removing dollars from a household’s tax base that Congress believes do not really constitute income (a “normative” adjustment).<sup>209</sup> They are also easy to administer as the taxpayer simply claims them on her return. The tax savings on exclusions and deductions are greater for higher income taxpayers because, as explained earlier, the amount excluded or deducted would be taxed at a higher marginal rate.<sup>210</sup> But this should not be a concern from a policy perspective because the amounts removed do not fall within a normative definition of income and so are not properly taxable in the first place.

More controversially, Congress has also employed exclusions and deductions to accomplish social policy. For example, the tax code provides a deduction for college tuition and fees up to \$4,000 per year to encourage

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<sup>207</sup> Id.

<sup>208</sup> GRAETZ & SCHENK, *supra* note \_\_ at 211.

<sup>209</sup> The most widely acknowledged definition of income, often considered “normative” in the sense of establishing the conceptual understanding of what ought to be taxable, is the Haig-Simons definition, GRAETZ & SCHENK, *supra* note \_\_ at 84. This definition is paraphrased as a person’s change in wealth plus her consumption during a particular tax period, ROBERT M. HAIG, *The Concept of Income – Economic and Legal Aspects*, IN THE FEDERAL INCOME TAX 1, 7 (Haig ed., 1921); HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (Univ. of Chic. Press, eds., 1938). Increases or reductions in a taxpayer’s tax base in order to get closer to this definition of income are considered normative adjustments. As an example, the Code allows households to deduct certain unreimbursed job expenses on the belief that dollars a taxpayer must spend in order to make taxable income are not really income. 26 C.F.R. 1.67-1T(a)(1)(i) (2017).

<sup>210</sup> See text accompanying footnotes \_\_ through \_\_.

taxpayers (and their dependents) to go to college.<sup>211</sup> It is when influencing social policy that exclusions and deductions are susceptible to becoming upside down subsidies because they are more valuable to high income taxpayers than to low income ones.<sup>212</sup> In fact, many have questioned why Congress, when its intent is to encourage certain social behavior, doesn't use a more flexible, less regressive mechanism like grants.<sup>213</sup> To address this problem, many exclusions and deductions come packaged with income caps and other income-sensitive benefit limits.<sup>214</sup> If not carefully crafted, exclusions and deductions meant to encourage social behavior can be regressive, overbroad and blunt instruments.

This is the case with the homeowner subsidies. The income and benefit limitations on homeowner subsidies do not meaningfully alter their regressive qualities.<sup>215</sup> It is the reason that the subsidies don't even do a good job of accomplishing their ostensible purpose of making homeownership more accessible. While some commentators have identified normative or administrative justifications for each of the subsidies that could account for their packaging as deductions and exclusions,<sup>216</sup> the more plausible read is that they ultimately took the form of what was at the times they originated the simplest and most conventional mechanisms for tax preferences, without much regard for their regressivity or effectiveness in actually promoting homeownership. Understanding these design motivations also helps in understanding why their current structure would be difficult to make much "smarter" in the way this article envisions.

### 3. Political Entrenchment

Once entrenched, tax subsidies are very difficult to modify, even in

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<sup>211</sup> 26 U.S.C. § 222 (2017).

<sup>212</sup> Stanley Surrey, former secretary of the Department of Treasury, is viewed as the principal architect of the "tax expenditure budget" and calling attention to so called upside down subsidies contained in the tax code, *see, e.g., Stanley S. Surrey, The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C.L. REV. 679 (1976).

<sup>213</sup> *Id.*

<sup>214</sup> For example, among other limitations, the tuition and fees deduction cannot be claimed by a household whose adjusted gross income is greater than \$160,000 (if married, filing a joint return) or \$80,000 (if single, head of household or qualifying widow), and more than \$4,000 in total per year cannot be deducted, 26 U.S.C. § 222 (2017).

<sup>215</sup> See, *supra*, Parts I and II.

<sup>216</sup> See Boris Bittker, *Income Tax Deductions, Credits and Subsidies for Personal Expenditures*, 16 J.L. & Econ. 193, 200-01 (1973) (for a normative defense of SALT); See MARVIN A. CHIRELSTEIN & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION, 218-223 (Foundation eds., 13th ed. 2015) (showing how a normative argument might be made on behalf of the MID); See Kaling, *supra* note \_\_\_ (identifying administrative rationales, among others, offered for various iterations of federal tax code's treatment of home sale gains).

the face of substantial criticism. Taxpayers and industry groups come to expect the financial benefits associated with a particular tax break and, if those impacted are broad and powerful enough, any perceived cut back brings peril for those political actors who support it.

This has certainly been the case for the homeowner subsidies, long considered one of the third rails of American politics.<sup>217</sup> The subsidies benefit a powerful coalition of political interests. Those who receive the lion's share of the benefits are upper middle income households, who vote in high proportions and, even more significantly, make up the donor base of both major political parties.<sup>218</sup> Because housing prices are significantly higher in large coastal cities, homeowners in these areas also benefit disproportionately from the homeowner subsidies.<sup>219</sup> Interestingly, many of the more liberal politicians who would otherwise push hardest against subsidies distributed so heavily in favor of the wealthy represent these coastal cities and, in pursuit of their constituents' interests, defend the subsidies.<sup>220</sup> And then there is the highly vested and vociferous participation of two of the nation's largest and most broadly influential special interest groups – the National Association of Realtors and the National Association of Homebuilders.<sup>221</sup> At the first sign of any potential roll back of the homeowner subsidies, these groups spring to action and let their dissatisfaction be known in ways that have caused even the staunchest of tax loophole closers to balk.<sup>222</sup>

At first glance, political theorists would refer to the challenge of rolling back the homeowner subsidies as a case of reform that has concentrated costs and highly diffuse benefits, which is among the most difficult to enact.<sup>223</sup> That is to say that in this instance the losses resulting from eliminating all or part of the subsidies are concentrated among a distinct group who are highly motivated to vocalize opposition (and politically powerful).<sup>224</sup> Meanwhile, the resulting benefits would be spread out among

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<sup>217</sup> See, e.g., Bruce Katz, *Cut to Invest: Reform the Mortgage Interest Deduction to Invest in Innovation and Advanced Industries*, BROOKINGS INST: REMAKING FEDERALISM, RENEWING THE ECON., 5 (Dec. 6, 2012), <https://www.brookings.edu/research/cut-to-invest-reform-the-mortgage-interest-deduction-to-invest-in-innovation-and-advanced-industries/>.

<sup>218</sup> See, e.g., Matthew Desmond, *How Homeownership Became the Engine of American Inequality*, NYTIMES MAGAZINE (May 9, 2017), <https://www.nytimes.com/2017/05/09/magazine/how-homeownership-became-the-engine-of-american-inequality.html>.

<sup>219</sup> See *supra* note \_\_\_ and accompanying text.

<sup>220</sup> Desmond, *supra* note \_\_\_.

<sup>221</sup> *Id.*

<sup>222</sup> *Id.*; Ventry, *supra* note \_\_\_.

<sup>223</sup> Susannah Camic Tahk, *Making Impossible Tax Reform Possible*, 81 FORDHAM L. REV. 101, 114-115 (2013)

<sup>224</sup> *Id.*

the population at large, potentially simply through increasing the government's tax revenue. This means the potential beneficiaries have had little motivation to support reform.<sup>225</sup>

Some additional factors have added to the intractability of the status quo. The first is that even though the lion's share of the benefits go to upper middle and high income taxpayers, many households receive at least a small bump from the homeowner subsidies and, thus, see themselves as vested in their survival. For example, most homeowners can claim the capital gains exclusion on home sales, even if lower-income households see a much smaller benefit.<sup>226</sup> The second is that some economists and virtually all industry group experts have predicted a housing market Armageddon if the homeowner subsidies are removed.<sup>227</sup> This is predicated on the assumption that the subsidies have been capitalized into higher home prices which will fall if the subsidies disappear, decreasing the value of the principal asset of many homeowners.<sup>228</sup> Although the extent to which home prices would fall (and exactly for whom they would fall) is debatable, the mere notion that it could happen has had a stifling effect on reform.<sup>229</sup>

The end result is that the homeowner subsidies have come to function like entitlements, reserved primarily for upper two income quintiles of American households, rather than strategic investments, adaptable to different housing markets and capable of containing negative housing externalities. This is not to say that there is no hope for smarter homeowner subsidies. But that the tasks of designing and implementing them are challenging ones.

## V. IN SEARCH OF SMARTER HOMEOWNER SUBSIDIES

While they have proven very difficult to roll back, calls for reform of one or more of the homeowner subsidies are virtually unceasing. A long line of policy analysts, economists, tax experts and legislators from places that experience less benefit from the subsidies have turned the mortgage interest deduction, in particular, into a popular punching bag.<sup>230</sup> Three consecutive

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<sup>225</sup> *Id.*

<sup>226</sup> *Supra* note \_\_\_ and accompanying text.

<sup>227</sup> *See, e.g.*, Dennis R. Capozza, Patric H. Hendershott & Richard K. Green, *Taxes, Mortgage Borrowing and Residential Land Prices*, Brookings Conf. on Econ. Effects of Fundamental Tax Reform, 171-98 (1996).

<sup>228</sup> Margery Austin Turner, Eric Toder, Rolf Pendall, & Claudia Sharygin, *How Would Reforming the Mortgage Interest Deduction Affect the Housing Market*, March 2013 URBAN INST, <http://www.urban.org/sites/default/files/publication/23431/412776-How-Would-Reforming-the-Mortgage-Interest-Deduction-Affect-the-Housing-Market-.PDF>

<sup>229</sup> *Id.*

<sup>230</sup> *See supra* Parts II & III; *infra* Part V.

Presidential administrations have started down the path towards reform, although none to date has succeeded.<sup>231</sup>

### A. *An Assessment of Current Proposals*

Variations abound, but the proposals for reform by and large fall into two principal camps. The first camp seeks to eliminate or reduce the homeowner subsidies without replacing them.<sup>232</sup> At the root of this approach are contentions that the subsidies either don't work or are not defensible.<sup>233</sup> Common to this line of criticism are claims that homeowner subsidies unfairly preference homeowners over renters, inflate home prices and require all taxpayers to foot the bill for the housing preference of one segment of the population.<sup>234</sup> A more equitable approach would be to use the money spent on the subsidies to lower everyone's taxes and let them make up their own mind as to whether to rent or own.<sup>235</sup>

Recent Republican tax reform proposals emanate from this camp, although they are mindful of the political risks of proposing a complete elimination of long-standing tax breaks.<sup>236</sup> They propose significantly increasing the standard deduction, which would reduce the number of taxpayers who would find the MID and SALT valuable, while lowering marginal tax rates, which would reduce the value of these deductions to those who would still claim them.<sup>237</sup> Some proposals also call for imposing or lowering caps on one or more of the subsidies to limit who and to what extent homeowners, especially higher income ones, can claim them.<sup>238</sup> The tax revenue gained from these caps would be used to pay for lower tax rates.

The second camp wants to improve the performance of the

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<sup>231</sup> See, e.g., CONNIE MACK III ET AL., PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (Nov. 2005); U.S. Dep't of the Treas., *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals* (Feb. 2012), <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>; TRUMP PENCE, *Tax Reform That Will Make America Great Again* (last visited Aug. 7, 2017), <https://assets.donaldjtrump.com/trump-tax-reform.pdf> (hereinafter, "Trump Tax Plan").

<sup>232</sup> See, e.g., Stansel & Randazzo, *supra* note \_\_; Horpedahl & Searles, *supra* note \_\_.

<sup>233</sup> *Id.*

<sup>234</sup> *Id.*

<sup>235</sup> *Id.*

<sup>236</sup> STAFF OF H. WAYS AND MEANS COMM., 144TH CONG., A BETTER WAY: OUR VISION FOR A CONFIDENT AMERICA (TAX) (2016), [https://abetterway.speaker.gov/\\_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf](https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf); Trump Tax Plan, *supra* note \_\_; STAFF OF H. WAYS AND MEANS COMM., 145TH CONG., TAX CUTS AND JOBS ACT (DRAFT) (2017), <https://waysandmeans.house.gov/taxreform/>.

<sup>237</sup> *Id.*

<sup>238</sup> *Id.*

homeowner subsidies, and in particular the MID, in making homeownership more affordable for those who are financially constrained. The central contention in this camp is that the subsidies would work better if they were built better. Most of these proposals call for converting the mortgage interest deduction to a tax credit designed to ensure low and middle income homebuyers can take advantage of it.<sup>239</sup>

A tax credit is a dollar for dollar reduction of how much a taxpayer owes, as opposed to an exclusion or deduction, which merely reduces the amount of income on which the taxpayer must pay tax.<sup>240</sup> So a tax credit is potentially of equal value to all taxpayers, no matter their tax bracket, as long as they have tax liability to offset. Some tax credits go further and are “refundable,” which means the IRS will pay the full amount of the credit to the person claiming it even if the credit exceeds the claimant’s tax liability (or the claimant has no tax liability at all).<sup>241</sup> These features make the tax credit approach popular among reformers who seek to use the tax code to encourage homeownership without creating an upside down subsidy. Capping the amount of a mortgage that qualifies for the credit goes even further in equalizing the benefit. For example, a 2005 tax reform panel established by President George W. Bush recommended converting the mortgage interest deduction to a flat tax credit equal to 15% of the mortgage interest a homeowner pays each year, but limiting the maximum amount of the mortgage eligible for the credit to 125% of a community’s median local home price.<sup>242</sup>

This article agrees with both camps that the homeowner subsidies ought to be reformed. The evidence is overwhelming that the current subsidies primarily encourage those who are relatively affluent and would already buy homes to buy larger and more expensive ones. This is neither the purported objective of the subsidies nor responsive to a separate market failure.

This article agrees with the second camp, but disagrees with the first camp as to the defensibility of the concept of homeowner subsidies. Ensuring

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<sup>239</sup> See, e.g., Will Fischer & Chye-Ching Huang, *Mortgage Interest Deduction is Ripe for Reform*, CENT. ON BUDGET AND POL’Y PRIORITIES, Table 1 (June 25, 2013), <https://www.cbpp.org/research/mortgage-interest-deduction-is-ripe-for-reform> (comparing five such proposals); Alan Viard, *Replacing the Home Mortgage Interest Deduction*, BROOKINGS INST. (Feb. 26, 2013), [https://www.brookings.edu/wpcontent/uploads/2016/06/THP\\_15WaysFedBudget\\_Prop8.pdf](https://www.brookings.edu/wpcontent/uploads/2016/06/THP_15WaysFedBudget_Prop8.pdf).

<sup>240</sup> See, e.g., GRAETZ & SCHENK, *supra* note XX, at 234.

<sup>241</sup> See, e.g., 26 U.S.C. § 32 (2012) (the Earned Income Tax Credit).

<sup>242</sup> CONNIE MACK III ET AL., PRESIDENT’S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM (Nov. 2005); see also, Fischer & Huang, *supra* note \_\_ (other proposals for conversion to tax credit each include an upper limit on amount of mortgage eligible for credit).

that a sufficient supply of affordable housing exists to shelter citizens is a legitimate interest of government. Housing affordability is a persistent and growing challenge for low and middle income households throughout the country, especially in this era of growing income disparity. Moreover, although the subject of debate, many have cited to the positive internalities and externalities associated with homeownership.<sup>243</sup> So if the government is to be in the field of subsidizing housing at all, then making homeownership more attainable and affordable, as an alternative to renting, is defensible. The proposals from the second camp are undeniably more efficient and equitable ways of accomplishing that objective than the current homeowner subsidies, and very likely more so than proposals from the first camp.<sup>244</sup>

However, the proposals from these two camps are not, on their face, smarter subsidies in the way Part IV describes. One could speculate that either an elimination or roll back of the current homeowner subsidies or a conversion to an affordability oriented tax credit might incidentally reduce some of the negative housing externalities discussed in Part III. For example, higher income households would receive either no or less mortgage based tax relief under any of those proposals and, thus, have less incentive to seek out larger and more expensive homes in exclusive neighborhoods. Also, lower and middle income and minority households might see lower housing prices (if one or more of the current homeowner subsidies are eliminated) and/or increased buying power (if affordability-oriented tax credits are adopted) and so presumably would have greater ability to move into and integrate neighborhoods of opportunity. On the other hand, one could also speculate as to how other externalities might be exacerbated. The push of additional households into more affluent suburban and exurban areas could exacerbate sprawl and accelerate disinvestment and further isolation of marginalized communities. Furthermore, the proposals from the two main camps are not adaptable to address the varying range of strengths and challenges faced by different housing markets.

The bottom line is that none of the proposals from these two camps are specifically engineered to be “smarter” as this article envisions. They represent missed opportunities to turn homeowner subsidies into tools for meaningfully reducing negative housing externalities. The aim of the rest of this article, then, is consider whether and how smarter homeowner subsidies might be engineered.

A critical starting point is to recognize that different homeowner

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<sup>243</sup> See, e.g., Edward L. Glaeser & Jessie M. Shapiro, *The Benefits of the Home Mortgage Interest Deduction*, 3 (Nat’l Bureau of Econ. Research, Working Paper No. 9284 2002).

<sup>244</sup> One caveat, however, is that policymakers would need to consider whether broadly available tax credits would simply be capitalized into higher home prices in supply-constrained housing markets.

choices result in different amounts and types of housing externalities. Accordingly, rather than rewarding homeowner decisions at large and in roughly equivalent ways, smarter homeowner subsidies should be equipped to reward certain decisions, but not others, or to do so in varying amounts, according to the housing externalities they generate.

A smaller contingent of reformers have offered ideas on allocating homeowner subsidies more strategically and selectively. As part of a package of reforms aimed at improving affordability in inelastic, supply constrained housing markets, Edward Glaeser and Joseph Gyourko have called for capping the mortgage interest deduction for homeowners in those markets and rebating the resulting tax revenue to local government in exchange for its efforts to increase housing supply.<sup>245</sup> The goal would be to reduce overall home prices and allow more households to access these opportunity-rich markets.<sup>246</sup> In the midst of cleanup efforts from the foreclosure crisis, Alan Mallach called for eliminating or scaling back the MID and investing the tax revenue gained into a package of investor and homeowner tax credits to encourage private reinvestment in “tipping point” neighborhoods.<sup>247</sup> Roberta Mann proposed replacing the MID with tax credits that incentivize the purchase of modest sized homes and those located near public transit as a strategy for reducing urban sprawl.<sup>248</sup> Meanwhile, Dorothy Brown, among others, has suggested limiting mortgage interest and property tax subsidies to those living in racially diverse neighborhoods.<sup>249</sup>

Each of these proposals is thoughtfully formulated for the housing market problem it seeks to address. In that sense, each calls for a smarter form of homeowner subsidy and is a proposal worth consideration. That said, each drills down on only one type of problem or negative housing externality, and some focus on a challenge unique to certain types of housing markets. The purpose of this article is to think more systemically and with the aim of identifying a viable approach for designing homeowner subsidies capable of addressing a collection of different housing externalities across many

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<sup>245</sup> EDWARD L. GLAESER & JOSEPH GYOURKO, RETHINKING FEDERAL HOUSING POLICY, 142-168 (Nat’l Res. Initiative ed., 2008)

<sup>246</sup> *Id.*

<sup>247</sup> These are neighborhoods, which HUD would select, that would have experienced a large number of foreclosures, but still have significant assets and market building potential. Alan Mallach, *Cut to Invest: Create New Bond and Tax Credit Programs to Restore Market Vitality to America’s Distressed Cities and Neighborhoods*, BROOKINGS INST. (Dec. 6, 2012), <https://www.brookings.edu/wp-content/uploads/2016/06/06-land-use-bonds-taxes.pdf>.

<sup>248</sup> Roberta F Mann, *The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction*, 32 ARIZ. ST. L.J. 1347 (2000).

<sup>249</sup> Dorothy A Brown, *Shades of the American Dream*, 87 WASH. U. L. REV. 329, 371-74 (2009). See also, Rothstein, *supra* note \_\_ at \_\_.

different types of markets and submarkets.

### *B. Examining Comparable Subsidies*

Fortunately, the slate is not completely blank. State and local governments are increasingly using demand-side tax subsidies to influence business and homeowner location and form decisions when they believe doing so will generate sufficient public benefit within their boundaries to outweigh the forgone taxes. In fact, the driving force for doing so has often been to combat negative externalities, like those following from chronic economic or housing disinvestment. The body of public finance research that has emerged on the efficacy of these subsidies is worth examining.

A good starting point is the track record on demand-side tax subsidies meant to attract and retain businesses, and encourage job creation. Although aimed at businesses rather than homeowners, the record is deeper and more established, as many states and localities have engaged in this practice for several decades.<sup>250</sup> In fact, the practice has become so pervasive that most businesses seeking to relocate (or simply considering whether to stay put) have come to expect generous state and local tax abatement to be a part of the package and often insinuate that they are prepared to go to the highest bidder. This has led to an unhealthy level of competition and a race to the bottom among states and cities, in which subsidies are so broadly available, overly generous and free of conditions that they become unhinged from accomplishing discernible and justifiable public benefits.<sup>251</sup>

In this failure lies an important lesson about the value of carefully limiting and targeting demand-side tax subsidies. Among those economists and policy analysts who support business attraction and retention tax subsidies, the prevailing opinion is that subsidies for which the benefits justify the costs are those that are carefully targeted and monitored.<sup>252</sup> This includes being geographically limited (to those places under great fiscal stress or where a market failure truly acts as a barrier to entry), right-sized in terms of amount, scope and class of eligible recipients to tie closely to the problem the subsidy seeks to overcome, periodically evaluated to make sure the subsidy works, and retractable if the business isn't holding up its end of the bargain.<sup>253</sup> Even many of those skeptical about such subsidies acknowledge

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<sup>250</sup> Dalehite, E. G., Mikesell, J. L., & Zorn, C. K. (2005). Variation in property tax abatement programs among states. *Economic Development Quarterly*, 19(2), 157-173.

<sup>251</sup> *Id.*

<sup>252</sup> *Id.*; see also, Sands, G., Reese, L. A., & Khan, H. L. (2006). Implementing tax abatements in Michigan: A study of best practices. *Economic Development Quarterly*, 20(1), 44-58.

<sup>253</sup> *Id.*

that carefully constructed subsidies approved after a thorough and open cost-benefit discussion may sometimes be justified.<sup>254</sup>

Although the subject of less study, even more substantively relevant is the experience of local governments that have used property tax abatement to try to induce prospective homebuyers to buy new homes or rehabilitate existing homes within their boundaries. Numerous cities have adopted policies like this in response to steep population declines.<sup>255</sup> Their stated objective is typically to combat the negative externalities that result from chronic disinvestment in their communities, like the decimation of the local tax base and the human, social and economic costs associated with deteriorating neighborhoods.<sup>256</sup>

Here are some of the lessons learned concerning taxes, subsidies and homeowner decisions. First, tax rates and overall tax burdens associated with purchasing in different jurisdictions within a region are influential in homebuyer decisions as to where to locate, especially where supply is elastic (i.e. comparable alternatives exist in nearby communities).<sup>257</sup> Subsidies, in the form of tax breaks aimed at prospective home buyers, are likewise effective at influencing behavior.<sup>258</sup> However, they are not the exclusive, nor even necessarily the driving factor, as to where a homebuyer chooses to purchase.<sup>259</sup> Furthermore, although subsidies can influence behavior, the challenge is in achieving the desired results.<sup>260</sup> For example, residential property tax abatement in Cleveland, Ohio has been successful in attracting new high income residents to the city, improving neighboring property values and even in creating net fiscal gain for the city's tax base, yet has not yet reversed overall population decline nor improved certain important neighborhood outcome measurements.<sup>261</sup>

Success appears to be a result of several factors. These include

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<sup>254</sup> See, e.g., William H. Bowen and Chang-Shik Song, Reasons for Misgivings about Local Economic Development Initiatives, Chapter 10 in *The Road Through the Rust Belt*.

<sup>255</sup> Mark S. Rosentraub, Brian Mikelbank, & Charlie Post, *Residential Property Tax Abatements and Rebuilding in Cleveland, Ohio*, 42 STATE & LOCAL GOV'T REV. 104 (2010).

<sup>256</sup> *Id.*

<sup>257</sup> Erik Johnson & Randall Walsh, *The Effect of Property Taxes on Location Decisions: Evidence from the Market for Second Homes*, (Nat'l Bureau of Econ. Research, Working Paper No. 14793, 2009).

<sup>258</sup> Rosentraub, et. al., *supra* note \_\_\_\_.

<sup>259</sup> See, e.g., CENT. COLL. & PELLA AREA CMTY. & ECON. ALLIANCE, EXAMINING FACTORS THAT SHAPE THE RATE OF HOMEOWNERSHIP OF PELLA AND SIMILARLY SIZED MUNICIPALITIES (2017), <http://kniakrls.com/wp-content/uploads/2017/05/Phase-3-Final-Report.pdf>.

<sup>260</sup> *Id.*; Doreen Swetkis, *Residential Property Tax Abatement: Testing a Model of Neighborhood Impact* (Dec. 2009) (unpublished Ph.D. dissertation) (on file with Cleveland State University).

<sup>261</sup> *Id.*

carefully tailoring homeowner subsidies to attract the types of development and homeowners that the locality has determined are important to meet its objectives.<sup>262</sup> They also include vigilance in monitoring the impact of the subsidy to ensure it is at the correct price point and has the right other features to actually influence consumer decisions, and the adaptability to adjust the policy as needed based on this data.<sup>263</sup> Subsidies seem to be most viable when not designed in isolation, but cognizant of other factors that affect homebuyer decision-making in that particular community (e.g., public school quality, proximity to metropolitan area, demographic trends) and ideally as part of a more comprehensive, community strategic development plan.<sup>264</sup> Finally, policymakers should take the long view in expecting results, as it may take several years to see the type of improvement that justifies the short-term costs of the subsidies.<sup>265</sup>

Collectively, these studies suggest the mix of qualities smarter homeowner subsidies should possess. These types of demand-side subsidies work best when they are tailored, limited, variable and complementary. **Tailored** means crafted to encourage specific behavior that squarely addresses the identified problem. If the problem is deteriorating or antiquated housing stock and a market for housing exists, then appropriately tailored subsidies should fund home rehabilitation or new construction. If the problem is residential segregation, then tailored subsidies could include incentivizes for excluded homeowners to purchase in exclusive communities, or non-excluded homebuyers to purchase in excluded communities.

**Limited** means not too broadly available. Instead a subsidy should be restricted to those individual homeowner decisions demonstrated to achieve the subsidy's objective. If the objective of a subsidy is to offset chronic community disinvestment, then it should not be available to a homebuyer seeking to purchase in a healthy housing market.

Subsidies should be **variable** in the sense that they allow for variations across housing markets and submarkets. As discussed earlier, different markets face different problems and possess different strengths, and often contain multiple submarkets. Furthermore, homeowners or prospective home buyers within one market or submarket may not respond in the same way as those within others.

In a similar vein, the subsidies should be **complementary**, in that they

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<sup>262</sup> CENT. COLL. & PELLA AREA CMTY. & ECON. ALLIANCE, *supra* note \_\_\_\_.

<sup>263</sup> Rosentraub, et al., *supra* note \_\_\_\_ at 106 (citing to Portland, Des Moines and Tacoma, as cities that altered their residential abatement policies to better match homebuyer behavior).

<sup>264</sup> CENT. COLL. & PELLA AREA CMTY. & ECON. ALLIANCE, *supra* note \_\_\_\_; *see also* Claire DeWind, Jennifer Dickey, Ellen O'Neill, & Molly W. Metzger, *Tax Abatement in Saint Louis: Reforms Could Foster Equitable Development*, 2016 CSD Policy Brief 16, 16-21, <https://csd.wustl.edu/Publications/Documents/PB16-21.pdf>.

<sup>265</sup> Rosentraub, et al., *supra* note \_\_\_\_.

should support, not counteract, other federal, state and local efforts to address negative housing externalities. Ideally, subsidies should be designed so that they coordinate with appropriate community planning and the investment of other private, public and philanthropic resources.

As a final note, it bears mention that state and local government tax abatement as a means to attract development is frequently criticized for being inequitable. This is because relieving the tax burden of one party typically means that other taxpayers within the jurisdiction must make up for this forgone revenue, or the jurisdiction goes without the revenue meaning schools and other local services suffer. Equity objections may be less intense with federal subsidies, because the tax burdens at issue are spread out across the entire country rather than across a city. Furthermore, the current homeowner subsidies are, in fact, highly inequitable and regressive, and so smarter subsidies may very well serve as an improvement.<sup>266</sup> Nonetheless, a desirable quality of virtually any subsidy is that it “pencil out” – i.e., demonstrate a net gain and return on investment for the community. A study of the previously mentioned Cleveland property tax abatement showed that over time it generated a dollar and a half of property tax for every dollar abated, and this finding aided significantly in its renewal.<sup>267</sup>

### *C. Conceptual Models for Smarter Subsidies*

Part V, B. looked to state and local examples of smarter subsidies. This is because there are far fewer examples of federal-level, demand-side homeowner subsidies that aim to accomplish objectives other than rewarding homeownership at large or making it more affordable. Perhaps this is because it is challenging to conceive of a subsidy (or collection of subsidies) that works across thousands of different housing markets that experience and are responding to a range of different housing externalities in a variety of different ways. There is an inherent tension between the highly tailored qualities of the ideal subsidy and designing an approach that could work across the board. Nevertheless, three models present theoretically plausible approaches and are worth discussion here.

#### 1. Subsidy Eligible/Ineligible Zones

The first model is to create a uniform tax subsidy aimed at reducing homeownership costs (ideally a refundable tax credit, to fix the distributional

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<sup>266</sup> See *infra* Part II.

<sup>267</sup> Thomas Bier, Abigail Horn, Brian Mikelbank, Charlie Post and Mark S. Rosentraub, *Cleveland’s Residential Tax Abatement Study: Its Impact, Effects and Value* (February 2007). Swetkis, *supra* at 3.

problems with the current subsidies), but make it only claimable by those whose homeownership decisions also reduce other negative housing externalities. An example would be limiting the subsidy to homeowners who live in communities that are disinvested or disinvesting. Or, limiting the subsidy to those who purchase median-sized homes in the built environment or within defined new development boundaries, in order to reduce suburban sprawl. Or, limiting it to those who purchase homes in racially integrated neighborhoods. The latter two solutions are similar to those posed by Professors Mann and Brown, respectively.<sup>268</sup> In any of these scenarios, the end result would probably be a complicated national map of subsidy eligible and ineligible zones.

A model like this would have the potential to reduce whatever negative housing externality or externalities at which the subsidy was aimed on a grand scale. Taking the example of a subsidy aimed at encouraging homeownership in disinvested communities, homeowners in these communities would receive a considerable discount on their costs, while homeowners in communities with normally functioning housing markets would not. Using a hypothetical \$4,000 annual refundable tax credit,<sup>269</sup> a homeowner in a qualifying community would receive a \$40,000 discount on housing costs over a ten-year period (the average homeowner tenure). This level of subsidy would presumably drive some segment of homeowners to purchase homes in disinvested communities and others to stay put. Demand for homes in qualifying communities would probably increase, as would private investment, home prices and the tax base. Over time, increased tax revenue should help to improve public services and decrease crime, public health risks and infrastructure concerns.

There are, however, several challenges with a solution along these lines. One relates to the degree of tailoring that may be required to ensure that the subsidy accomplishes what it sets out to do. For example, what amount of subsidy would be necessary to move the needle and impact homeowner decisions? Would that amount need to vary by community based on regional home prices? What constitutes a “disinvested community”? At

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<sup>268</sup> See *supra* notes \_\_\_ & \_\_\_.

<sup>269</sup> Merely for illustration’s sake, I arrived at a \$4,000 annual credit by dividing the amount of tax revenue currently forgone due to the mortgage interest deduction (\$63.6 billion) among the percentage (22.1%) of current U.S. homeowners (75 million) who would live in disinvested communities if current U.S. homeowners were distributed evenly across U.S. census tracts. The quotient equals \$3,837, which I rounded up to \$4,000. See *supra* notes \_\_\_ and \_\_\_ for the forgone tax revenue due to the MID and the percentage of census tracts that are within disinvested communities. The number of U.S. homeowners came from a 2016 Pew Research Center analysis of U.S. Census Bureau data. See <http://www.pewresearch.org/fact-tank/2017/07/19/more-u-s-households-are-renting-than-at-any-point-in-50-years/>.

what point is it no longer disinvested such that subsidies can be eliminated? If a community reached that point, would a separate subsidy need to remain in place for lower income households to keep homes affordable as prices rise?

And how would policymakers account for other, more community specific variations? For example, a disinvested community nearer to a high growth area might turn around quickly, at which point gentrification becomes a concern. On the other hand, in a Rust Belt city with too much housing stock, the city might prefer to limit the subsidy to “tipping point” neighborhoods (those with greater turnaround potential), and redeploy largely abandoned neighborhoods to park space or wetland recovery. In dealing with thousands of communities around the country, it is easy to imagine that many different types of development scenarios could emerge, and that some level of variability in how a subsidy is deployed would be important. Analogous sets of questions would undoubtedly arise for subsidies targeted at other negative housing externalities.

Another challenge is that the disinvested community subsidy addresses only one type of negative housing externality. Would it aid, hamper or be inconsequential as it relates to other externalities? It is reasonable to speculate that some overlap exists. For example, incentivizing moves to racially integrated neighborhoods would probably reduce socio-economic segregation, given that poverty rates are significantly higher among certain racial groups. Doing so, might also aid in the reduction of suburban sprawl because minority households are disproportionately located in older, urban areas that white households may move into in order to get the subsidy. On the other hand, it is conceivable that this type of subsidy may also have the opposite effect. More economically mobile, minority households may move from older urban areas into newer, suburban and exurban communities, increasing demand for this type of housing and further isolating those left behind. Policymakers would then be left either to determine which negative externalities matter most, and prioritize accordingly, or to try and craft a map of subsidy eligible and ineligible areas that is responsive to each of the externalities or most socially beneficially in the aggregate. Then, there is the question of how to treat individual homes that cause fewer negative housing externalities (say a home fully powered by solar energy), but sit in non-qualifying communities (e.g., one with a thriving local housing market). Marshalling information to pinpoint areas and homes that represent socially optimal homeowner decisions would probably be daunting.

Yet another concern is the potential impact on homeowners living in areas or in homes that would no longer qualify for homeowner subsidies. As demand would increase for qualifying communities and homes, it inevitably would decrease for non-qualifying communities and homes. This would reduce home prices and homeowner equity in the latter, although the extent

is difficult to know and depends to some degree on how fully capitalized the current homeowner subsidies are into a particular community's home prices. Nonetheless, some homeowners could see a significant drop in the value of their homes, which could call into serious question the fairness and political viability of this type of approach.

## 2. A La Carte Subsidies

A second model would involve Congress authorizing a broad range of separate subsidies, each targeted at a type of homeowner decision that serves to reduce a type of negative housing externality. Think of this as the à la carte approach. One subsidy, like a tax credit that offsets a percentage of a homeowner's mortgage interest expenses, could be available to most homeowners in order to promote affordability. On top of that could be stacked additional subsidies to encourage specific homeowner behavior like making qualifying home repairs in a community with older housing stock, purchasing a LEED certified home and purchasing a home in an integrated neighborhood.

Congress has actually used this model in the recent past. Between 2005 and 2016, it provided a collection of federal income tax credits to homeowners who purchased energy efficient appliances, made specified home improvements that increase energy efficiency and installed renewable energy systems for their homes.<sup>270</sup> A principal underlying rationale was to encourage homeowner purchases that reduced the negative environmental externalities resulting from residential energy consumption.<sup>271</sup> Between 2008 and 2010, Congress also made available a tax credit of up to \$8,000 for first-time homebuyers (later expanded to include many other homebuyers) to help stabilize the national housing market as home prices tumbled during the foreclosure crisis.<sup>272</sup>

The à la carte approach also has the potential to impact the behavior of a substantial number of homeowners and, therefore, reduce negative housing externalities on a large scale. The credits would offset the perceived or actual costs of certain socially beneficial homeowner behavior – like repairing an older home where the homeowner would otherwise be unlikely to fully recoup the costs. This helps not only the homeowner who gets the

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<sup>270</sup> 26 U.S.C. § 25C (2017); 26 U.S.C. § 25D (2017).

<sup>271</sup> Margot L Crandall Hollick & Molly F Sherlock, *Residential Energy Tax Credits: Overview and Analysis*, CONG. RESEARCH SERV., 4-7(2016), <https://fas.org/sgp/crs/misc/R42089.pdf>.

<sup>272</sup> The Federal first-time homebuyer credit was first introduced as part of the Housing and Economic Recovery Act of 2008. It was modified and extended via the American Recovery and Reinvestment Act. The credit was expanded and extended a third time under the Worker, Homeownership and Business Assistance Act of 2009.

subsidy, but also has a variety of potential spillover effects on neighboring homeowners whose homes might increase in value as a result and who then be more likely to make similar repairs.

One challenge with the presumably smaller,<sup>273</sup> à la carte subsidies is designing them so that they actually prompt the desired behavior and have the desired impact. Both the homeowner energy credits and first-time homebuyer credit faced questions as to whether they actually served as effective incentives.<sup>274</sup> The individual energy credits were relatively small and also subject to low overall caps raising concerns that they did not act as much of an incentive and instead were mostly claimed as a windfall by those who already planned to make the subsidized investments.<sup>275</sup> The homebuyer tax credit was larger, caused home purchases to rise over a two year period and probably helped keep the national housing market from total freefall.<sup>276</sup> But whether it increased the overall homeownership rate or even had a sufficient long-term stabilizing impact on housing prices are largely in question. Because the credit had an expiration date, many analysts wondered if it simply caused those who already planned to purchase a home to do so earlier.<sup>277</sup>

Moreover, the a la carte approach is potentially a scatter shot strategy. Unless carefully coordinated, a subsidy might support a homeowner decision that reduces one negative externality while simultaneously increasing others. For example, a homeowner might claim a renewable energy tax credit for putting solar panels on a new McMansion built on a floodplain.

Finally, as with the first approach, policymakers would face the challenge of crafting subsidies at the national level to work in thousands of different housing submarkets. A home rehabilitation tax credit that incentivizes the repair of a historic home in a tipping point neighborhood with rebound potential may make perfect sense. On the other hand, the use of that subsidy to repair an antiquated home in a mostly abandoned neighborhood where new construction or re-purposing is a better strategy may make much less sense.

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<sup>273</sup> I am assuming the overall pool of tax expenditures is not increasing, and thus a la carte subsidies would probably be smaller because that pool would have to be split up across several subsidies, rather than delivered as one larger subsidy.

<sup>274</sup> See, e.g., Hollick & Sherlock, *supra* note \_\_, p. 8-9; see also, Karen Dynan, Ted Gayer & Natasha Plotkin, *The Recent Homebuyer Tax Credit: Evaluation and Lessons for the Future*, BROOKINGS INST. (June 28, 2013), <https://www.brookings.edu/research/the-recent-homebuyer-tax-credit-evaluation-and-lessons-for-the-future/>.

<sup>275</sup> Hollick & Sherlock, *supra* note \_\_.

<sup>276</sup> Dynan, Gayer & Plotkin, *supra* note \_\_; see also, Tricia Snyder and Elizabeth Ekmekjian, What are the Impacts of the Home Buyer's Tax Credit on Housing and the Economy?, *Research in Business and Economics Journal*.

<sup>277</sup> *Id.*

### 3. Community and Project Level Subsidies

A third model represents the other side of the coin, in that it is more bottom up than top down. Congress could authorize homeowner subsidies to be allocated selectively on a community-by-community or project-by-project basis, and in coordination with other community or public sector efforts to address negative housing externalities in a comprehensive way.

The subsidies could be deployed in a couple of different scenarios. One would be in support of housing development proposed as part of locally driven, community planning that meets federally prescribed standards. For example, in Cleveland, Ohio, a coalition of community organizations, city and county agencies and local technical assistance providers have prepared a comprehensive land use plan in response to a recognition that regional population decline and changing land-use patterns means the city has more developed, but vacant land than it can sustain in the foreseeable future.<sup>278</sup> The plan, called “Re-imagining a More Sustainable Cleveland,” has been adopted by the Cleveland City Planning Commission and it proposes strategic redeployment of land in ways that stabilize and begin to revitalize neighborhoods with development potential, while devoting other land to green infrastructure (e.g. parks and storm water management), agriculture and energy generation.<sup>279</sup> If a plan like this met prescribed standards for community participation, sustainability and the reduction of negative externalities, the federal government could approve homeowner subsidies for use in those neighborhoods that the plan targeted as having the potential for residential revitalization. In this way, the subsidies would be more selectively available in circumstances where informed local actors could demonstrate that spurring homeownership or a particular type of homeowner behavior would be highly beneficial. The subsidies would serve as one arrow in a quiver of strategies that a community might use to engage in strategic development.

Another scenario could be in support of other government funded housing development programs aimed at reducing one or more negative externalities. For example, over the past few decades, two major federal programs – HOPE VI and now the Choice Neighborhoods Initiative – have sought to replace distressed public and assisted housing projects with better quality, mixed-income housing in order to reduce residential segregation and

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<sup>278</sup> CLEVELAND CITY PLANNING COMM., RE-IMAGINING A MORE SUSTAINABLE CLEVELAND (Kent State eds., 2009), <https://www.scribd.com/document/64257913/Re-Imagining-A-More-Sustainable-Cleveland-Report>.

<sup>279</sup> *Id.*

break up concentrations of poverty.<sup>280</sup> Very recently, a coalition of community development advocates launched a campaign for a new form of financing called the Neighborhood Housing Tax Credit, aimed at incentivizing developers and lenders to finance the construction and rehabilitation of housing that would attract moderate and middle income households to disinvested neighborhoods.<sup>281</sup> These are both examples of supply side initiatives aimed at reducing negative housing externalities. Offering homeowner subsidies directly to potential homebuyers in developments like these would provide a corresponding demand side incentive that could significantly increase the likelihood of success of these programs.

This third approach is also the flipside of the other two in terms of its advantages and challenges. It serves as a much better vehicle for incorporating the unique aspects of each particular community's housing markets and submarkets into the allocation of subsidies. It coordinates with community planning and the investment of other public resources, and thus is likely to be highly complementary to local efforts to impact housing conditions. Because targeting of the subsidies originates at the local level where knowledge of the housing market is greatest identifying development that addresses all or most of the negative externalities also seems more achievable. The involvement of local policymakers might make monitoring the impact of the subsidies over time and adapting them as necessary much easier.

Of course, there are challenges as well. This model would not catalyze substantial changes in homeowner behavior in one fell swoop as the other models potentially would. Changes would come about more gradually and sporadically. Deciding on and overseeing the allocation of subsidies on a project-by-project basis would also be more administratively burdensome and necessarily require significantly more federal time, attention and expense.

This approach also assumes, especially in the scenario in which the subsidies would complement community planning, capacity at the local level across the country to generate comprehensive and useful plans that meet federal standards and take into account multiple forms of housing externalities. Federal funds and involvement to help interested, but capacity lacking, communities achieve this would probably be necessary. This is to

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<sup>280</sup> TARYN GRESS, SEUNGJUNG CHO & MARK JOSEPH, HOPE VI DATA COMPILATION AND ANALYSIS, 7 (Dep't of Hous. and Urb. Dev. eds., 2016), <http://nime.case.edu/wp-content/uploads/2015/08/HOPE-VI-Data-Compilation-and-Analysis.pdf>.

<sup>281</sup> See NEIGHBORHOOD HOUSING TAX CREDITS, <https://www.neighborhoodhomestaxcredit.org/outreach> (last visited Aug 8, 2017) (summary of its recent campaign).

say nothing of the increased susceptibility of locally driven processes to political and private interest influence and corruption. Coordinating this type of a program across such a large and diverse landscape could be a tall task.

On the other hand, the federal government does have experience in overseeing similarly structured programs. Of particular relevance is the Community Development Block Grant program, which involves the allocation of federal investments in community development to local governments for implementation in response to planning priorities identified at the local level.<sup>282</sup> Using the infrastructure of an existing program, like CDBG, to allocate homeowner subsidies, rather than starting from scratch, could help overcome some of the administrative concerns.

#### *D. Data and Innovation as Gateways to Smarter Subsidies*

A significant challenge to making homeowner subsidies smarter under any model is understanding the housing externalities at play within thousands of different housing markets and submarkets, and engineering the subsidies to be precise and sensitive enough to address these externalities. In this respect, the world is changing rapidly and in ways that portend success.

The real estate industry, like many others, is in the midst of a data revolution. Online sources are compiling and making readily available property specific data on everything ranging from owner and building information, mortgages and liens, code violations, past sales history, crime and fire history and more, previously available manually and through visits to multiple government offices.<sup>283</sup> Simultaneously, a data analytics industry has emerged. Firms in this industry have developed sophisticated algorithms and valuation models, which, coordinated with geographic mapping technology, can process spools of available data and translate it into digestible, real time, accurate market assessments of local housing conditions.

Predictably, much of the data analytics industry serves banks, insurance companies and mortgage servicers.<sup>284</sup> However, a separate and growing segment of the industry, consisting of both nonprofit and for-profit entities, focuses on community planning.<sup>285</sup> Community leaders and local

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<sup>282</sup> *Supra* notes \_\_ through \_\_, and accompanying text.

<sup>283</sup> *See, e.g.*, NEO CANDO: CASE WESTERN RESERVE UNIVERSITY, <http://neocando.case.edu/> (last visited Aug. 8, 2017)

<sup>284</sup> *See, e.g.*, CORELOGIC: DATA, <http://www.corelogic.com/about-us/data.aspx> (last visited Aug. 8, 2017).

<sup>285</sup> *See, e.g.*, DYNAMO METRICS, <http://www.dynamometrics.com/> ([last visited Aug. 8, 2017](#)); LOVELAND TECHNOLOGIES, <https://makeloveland.com/company> (last visited Aug. 8, 2017); THE CENTER FOR COMMUNITY PROGRESS, <http://www.communityprogress.net/the-help-you-need-pages-7.php> (last visited Aug. 8, 2017).

governments are working with these service providers to incorporate property and neighborhood specific data into more sophisticated, forward looking and sustainable development plans.

Examples of this type of planning are many. Cities like Detroit,<sup>286</sup> Cincinnati,<sup>287</sup> Kansas City,<sup>288</sup> and Memphis,<sup>289</sup> each confronted by large stockpiles of vacant and distressed properties, are creating data infused mapping interfaces covering every property within their boundaries. This visual mapping technology allows community leaders and agencies to more efficiently determine what code enforcement, demolition and rehabilitation strategies for which properties make the best (i.e. smartest) use of their resources. In Cleveland, a community development funding intermediary recently hired a “spatial econometrics” firm to use hedonic pricing models to determine which types of homes, if rehabilitated, would yield the highest increases in surrounding property values.<sup>290</sup> This is another data-based mechanism for prioritizing the spending of a city’s limited public and philanthropic revitalization funds, in this case specifically to maximize positive externalities on neighbors and the local tax base.

Smaller cities are getting into the game as well. Danville, Virginia, a former mill town, is just one example of a city with a size, location and economic base that suggests continued population stagnancy and perhaps even further contraction. Rather than simply letting development happen as it will and spread out further, Danville’s planning department worked with an urban development consulting firm to create a multi-tiered housing plan within the city’s current footprint. The plan delineates separate areas for targeted demolition, rehabilitation and growth based on what future homeowners are likely to seek and population projections.<sup>291</sup> Meanwhile, the

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<sup>286</sup> John Gallagher, *Start-Up Mines Data to Aid Blight Fight*, DETROIT FREE PRESS (Jan. 17, 2016), <http://www.freep.com/story/money/business/michigan/2016/01/16/blight-detroit-econometrics/78645606/>.

<sup>287</sup> Janis Bowdler, *Mapping Blight at the Parcel Level in Cleveland, Columbus and Cincinnati*, CLEVELAND PLAIN DEALER (Apr. 9, 2017), [http://www.cleveland.com/opinion/index.ssf/2017/04/mapping\\_blight\\_in\\_cleveland\\_co.html](http://www.cleveland.com/opinion/index.ssf/2017/04/mapping_blight_in_cleveland_co.html).

<sup>288</sup> Ellie Moxley, *To Tackle Blight Kansas City, Kansas, Will Crunch the Numbers*, KCUR (June 14, 2016), <http://kcur.org/post/tackle-blight-kansas-city-kansas-will-crunch-numbers#stream/0>.

<sup>289</sup> Madeline Faber, *Memphis Property Hub Using Micro-Level Data to Drive Solutions*, THE MEMPHIS DAILY NEWS (Aug. 8, 2016), <https://www.memphisdailynews.com/news/2016/aug/8/memphis-property-hub-using-micro-level-data-to-drive-solutions/>.

<sup>290</sup> *Rehab Impacts in Cleveland 2009-2015*, DYNAMO METRICS, <http://www.rehabimpact.com/> (last visited Aug. 8, 2017).

<sup>291</sup> Sandy Smith, *How to Shrink a Housing Market So It Can Grow Again*, NEXT CITY, (Oct. 24, 2016) <https://nextcity.org/daily/entry/shrink-housing-market-growth>.

Center for Neighborhood Progress, a national nonprofit, has begun offering publications and technical assistance aimed at helping communities large and small develop the capacity to use data to shape planning and revitalization decisions.<sup>292</sup>

For sake of illustration, the above examples have focused primarily on the use of property data, technology and analytics to address community disinvestment. But these advances are also taking place with respect to the other negative housing externalities this article addresses. For example, HUD has developed data-infused mapping tools for its fund recipients (state and local governments, and housing agencies) to use in measuring residential segregation within their boundaries and developing strategies to address it.<sup>293</sup> The EPA has developed “smart location” maps, designed to reveal block-by-block characteristics like proximity to jobs, transit options and walkability, to encourage home seekers to make choices that lessen greenhouse gas emissions and improve their health and access to amenities.<sup>294</sup>

#### *E. A Path Forward*

Demand-side subsidies can influence homeowner behavior. As discussed throughout Part V, if properly constructed, this can include encouraging homeowner decisions that impose fewer negative housing externalities (and create more positive ones). Rapid, recent advances in housing data, analytics and planning make the prospect of smarter homeowner subsidies increasingly more plausible.

So how to proceed? This article proposes that, while each model discussed in Part V, C. has potential advantages, the third is the best starting point. This is due to its flexibility. It is the most adaptable to community-by-community variations, can be integrated as a complement to other federal, state and local programs that subsidize housing, and lends itself most easily to experimentation and adjustment. In these ways, it holds the greatest potential for “smarter” subsidy design in the way this article envisions.

This article also proposes that certain features are important to include if proceeding with the third model. First, community or project-level homeowner subsidies should take the form of homeowner grants allocated through HUD, rather than as tax breaks provided through the Internal Revenue Code. HUD, after all, is a housing agency. It has a great deal of

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<sup>292</sup> See Alan Mallach, Center for Community Progress, *Neighborhoods by Numbers: An Introduction to Finding and Using Small Area Data* (2017).

<sup>293</sup> See, e.g., *Affirmatively Furthering Fair Housing Data and Mapping Tool*, DEP’T OF HOUS. AND URB. DEV. <https://egis.hud.gov/affht/#> (last visited Aug. 8, 2017).

<sup>294</sup> See, e.g., *Smart Location Mapping*, U.S. ENVTL. PROT. AGENCY, <https://www.epa.gov/smartgrowth/smart-location-mapping> (last visited Aug. 8, 2017).

experience allocating federal funding in response to community planning processes that identify localized funding needs. Just a few examples include the CDBG program,<sup>295</sup> the Neighborhood Stabilization Program<sup>296</sup> and the HOME Investment Partnerships Program.<sup>297</sup> The Internal Revenue Code, on the other hand, is not a good vehicle for delivering on social policy with as many moving parts as this would entail. Furthermore, there is a significant risk that highly tailored, community specific subsidies delivered as tax breaks could violate the Uniformity Rule of the U.S. Constitution.<sup>298</sup>

Second, local governments should serve as the applicants for and the ultimate distributor of homeowner subsidies within their boundaries. Congress and HUD would set the parameters for the housing objectives and types of homeowner decisions that the subsidies could support, and these would correlate closely with the negative housing externalities discussed throughout this article. But local communities would identify the specific instances in which they would deploy the subsidies.

For example, a city grappling with disinvestment might identify several tipping point neighborhoods where an influx of new homeowners could provide the foundation for stabilization and a turnaround. This city might then propose in its application purchase grants for home buyers and local property tax offset grants for existing homeowners. HUD standards might additionally require that these grants advance (or at least not undermine) residential integration and environmental objectives. In addition, a community planning process should support the application for these types of subsidies. This is similar to the design of already existing HUD programs like CDBG, NSP and HOME.<sup>299</sup> The basic premise is that HUD provides oversight, but communities are given significant leeway in proposing the best specific uses of the funds.

Third, given that this type of a subsidy model represents a significant departure from the current model, it would be best initiated as a pilot program, limited in scope and subject to review, until its merits are demonstrated and

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<sup>295</sup> Supra note \_\_.

<sup>296</sup> Congress authorized three phases of the Neighborhood Stabilization Program. NSP 1 was authorized by the Housing and Economic Recovery Act (2008), NSP 2 by the American Recovery and Revitalization Act (2009) and NSP 3 by the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010).

<sup>297</sup> The statute codifying HOME is at 42 U.S.C. 12722.

<sup>298</sup> See U.S. Constitution, Section 8, Clause 1:

The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be *uniform* throughout the United States. (emphasis added)

<sup>299</sup> Supra notes \_\_ through \_\_.

its preliminary kinks worked out. In addition, Congress should strongly consider making this program competitive in its pilot phase in order to encourage innovation and to identify communities with the capacity to succeed.

Federal agencies have significant recent experience launching new funding programs in this manner. The second round of Neighborhood Stabilization Program funding involved a competitive application process in which local governments and nonprofit applicants had to demonstrate to HUD that their proposed use of the funds would help to stabilize targeted neighborhoods (among a number of other objectives, including environmental ones), resulted from a planning process and that they possessed the capacity to carry it out.<sup>300</sup> In a similar vein, the American Recovery and Reinvestment Act of 2009 provided \$4.35 billion for a competitive grant fund for state plans that accomplished a broad range of objectives related to improving educational outcomes, and might be used as models for other states.<sup>301</sup> This approach to funding has become a useful method for spurring innovation and reform within the public sector, as local actors are highly motivated by available funds to get creative in designing plans capable of success. Ultimately, a pilot phase may reveal that it is actually feasible and more efficient to allocate homeowner subsidies using the first or second models, or that some type of hybrid model would work best.

A pilot phase would also allow policymakers to determine the impact of the third model on housing affordability and equity concerns. Smarter homeowner subsidies, as discussed throughout this article, would involve direct, selectively available subsidies to private individuals influenced by data analytics, market factors and local leaders who are also focused on keeping or making their communities competitive. This raises well-merited and significant concerns regarding housing access and equity, especially as it relates to politically marginalized groups. Congress should include standards and safeguards to address these concerns, which HUD should be charged with implementing. Yet, it is reasonable to expect that this will not be a perfect science, and will take time. Separate study on what these safeguards would look like would be critical, but is beyond the scope of this article.

A pilot model would make sense for another reason. It may match best with the political challenges certain to follow from tackling reform as charged as that involving the homeowner subsidies. As Part IV discussed, any effort at changing the current homeowner subsidies will encounter immediate and stern resistance from the powerful interests benefiting from

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<sup>300</sup> *Supra* note \_\_\_\_.

<sup>301</sup> *Race to the Top Fund*, U.S. DEP'T OF EDUC. <https://www2.ed.gov/programs/racetothetop/index.html> (last visited Aug. 8, 2017).

them. This resistance may include invoking, not without merit, the potential for a drop in home prices that could result from a significant roll back of the subsidies. A more politically feasible scenario for reform would involve an incremental roll back of one or more of the current homeowner subsidies, by lowering the existing caps on the amount of gain that qualifies for the capital gains exclusion or the value of the mortgage or property that qualifies for the MID or property tax deduction. Proceeding in this way would primarily only affect the tax breaks of wealthy homeowners (and only on a portion of their tax breaks), be unlikely to significantly disrupt home prices and yield significant tax revenue for the federal government.<sup>302</sup> A portion of this revenue could then be devoted to piloting smarter homeowner subsidies.

It bears repeating here that the quest for smarter homeowner subsidies is not a call for abandoning homeowner subsidies that seek to make homeownership more affordable. The calls for more thoughtfully constructed tax credits aimed at low and middle homeowners, in what Part IV described as the second camp of proposals, is in a sense a smarter homeowner subsidy as it relates to home affordability. The goal of this article is not to work to the exclusion of this objective, but rather to advocate for subsidy reform that is also smarter as it relates to negative housing externalities. These two goals can and should be complementary.

## CONCLUSION

The prospect of smarter homeowner subsidies is tantalizing. When considering the sheer scale of what the federal government currently invests in homeowner subsidies that inure primarily to the benefit of higher income households and are completely insensitive to negative housing externalities, it is difficult not to wonder what a more carefully considered system of allocating subsidies might yield. If done right, a powerful tool could be added to the mix of federal housing strategies.

At the same time, the challenges to successfully implementing smarter subsidies on a nationwide basis are daunting, as this article identifies. In earlier eras, the potential for inequities, inefficiencies and problems in administration would likely have proven too difficult to overcome. Rapidly advancing technology and corresponding increases in planning sophistication at the community level should ultimately provide the opportunity for the federal government to persevere and get a much better return on its massive investment in homeownership. Participation and innovation at the

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<sup>302</sup> See Fischer and Huang, *supra* note \_\_\_, citing to proposals that would limit the mortgage interest deduction to 28% for all claimants or that would alternatively provide all homeowners with a 15% tax credit, limited to a \$500,000 mortgage and result in tens of billions of dollars tax revenue.

community level in designing these subsidies should be important catalysts to their success.