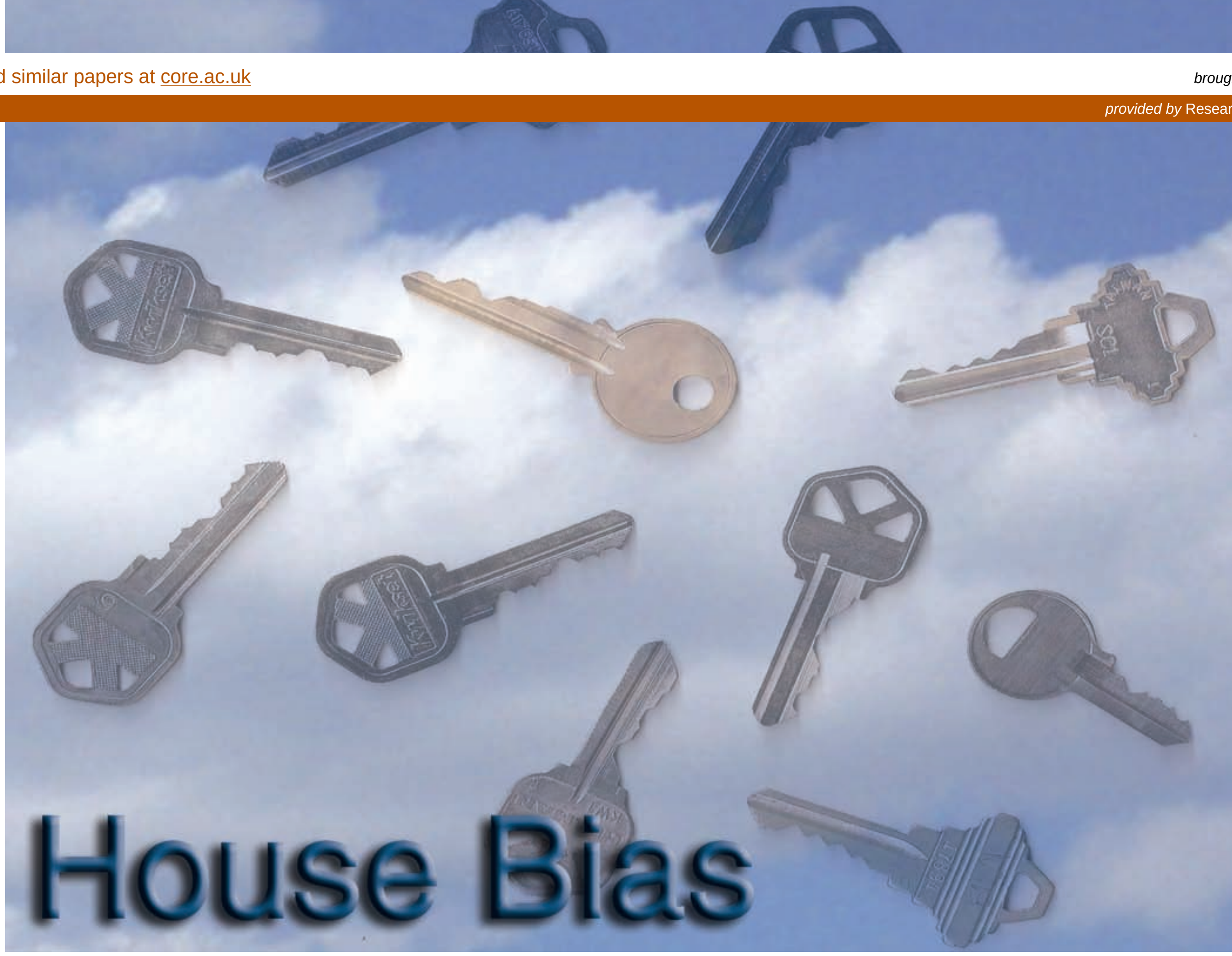


House Bias

The economic consequences of subsidizing homeownership

BY STEPHEN SLIVINSKI

Ask most people in America today whether buying a home is better than renting one, and you'll likely get a response that equates renting with stuffing money down a garbage disposal. The idea of homeownership today is not one that simply evokes the comfort or pride of living in a place of one's own. Instead, it's become part of a common investment philosophy.

But if you ask Edmund Phelps, the Nobel Prize-winning economist from Columbia University, he'll proudly declare that he doesn't own a home. And to him, that's not a bad thing. "It used to be that the business of America was business," said Phelps in August 2008 to Bloomberg News. "Now the business of America is homeownership." In fact, many economists will tell you that the American love affair with homeownership has some consequences that you won't normally hear discussed.

Yet, despite the warning of some experts, the federal government continues to play a role as matchmaker in this affair. Policymakers have been promoting homeownership as a goal for most Americans since the Great Depression. Even in the late 20th century, when the number of American homeowners was at historic highs already, the policy initiatives continued to expand. In 1995, when the homeownership rate as measured by the U.S. Census Bureau was about 65 percent, President Bill Clinton made it an explicit goal of his administration to boost it to 67.5 percent by the year 2000. So he enlisted his secretary of housing and urban development, Henry Cisneros, to spearhead a "National Homeownership Strategy." The policies that resulted encouraged a loosening of lending standards.

The race to encourage homeownership is a bipartisan one. President George W. Bush, while not committing himself to a specific number, proposed raising the homeownership rate for minority families through a government-led "Homeownership Challenge." The goal was to lower "barriers" to homeownership by using federal money to help low-income families make their downpayments and encourage "below-market-rate" investments.

For most of the country's history, however, the odds were that you did not own the home you lived in unless you were a farmer. Nor is it clear that owning a home is in the best interest of some who hold a mortgage today.

The homeownership rate is about 68 percent now. Perhaps the best policy question is no longer why the homeownership rate in the United States is so low. A question that economists might ponder instead is: Why should we want the homeownership rate to be so high?

The Suburbanization of America

To understand how the ranks of homeowners grew, we need to understand the spread of homeownership in 20th century America. It is largely a tale of how the urban and economic landscape changed and the rise of suburbanization.

The suburbs began to crop up in the 1890s, around the same time that streetcars became a viable way for people to commute between the outer edge of metropolitan areas and the city center. Through the turn of the century and into the 1920s, the outer fringes of the city became a high-population growth area. Yet even in those days owning a home was still largely a rural phenomenon. The nonfarm homeownership rate in 1920 was 41 percent, but the homeownership, rate of farmers was 58 percent.

The Great Depression didn't alter metropolitan settlement trends in any fundamental way, although it did reduce the number of people who owned homes. But after World War II, the rush to the suburbs and, consequently, the upward shift in homeownership, was dramatic. Whereas it took about 40 years after the turn of the 20th century for the overall homeownership rate to crawl upward by 2 percentage points, it took only the 20 years between 1930 to 1950 for the rate to jump 7 percentage points, from 48 percent to 55 percent.

Harvard University economist Edward Glaeser suggests this illustrates what is now practically an Iron Law of housing economics: People who live in urban areas are usually renters, and those who live in suburbs are usually owners. "If you're trying to explain the differences in homeownership between cities in the United States, the physical structure of the homes is the overwhelming variable," says Glaeser. Or, to put it another way, the people who live in detached single-family homes tend to own them — and most of those sorts of housing units are concentrated in suburban areas.

Homeownership rates in the Fifth District illustrate the same general trend. Since the 1950s, the ownership rate in an urban area like Washington, D.C., has been substantially lower than the national average. Meanwhile, other states in the Fifth District tended to have a higher-than-average homeownership level. The 1950s housing boom spurred a very dramatic rise in South Carolina particularly. And the fact that the most rural state in the District — West Virginia — also has the highest homeownership rate fits the pattern.

A subplot in the suburbanization tale is the growth of mortgage lending. In the decades prior to the Great Depression, mortgage lending to home buyers wasn't a booming industry. In 1910, only a third of the nonfarm owner-occupied home purchases were mortgaged. Those mortgages that did exist originated with local savings and loan institutions which mainly did business in their immediate geographic area.

The homeownership boom of the post-war years was preceded by specific public policies geared toward making the market for housing credit national in scope. President Franklin Roosevelt's New Deal legislation in the 1930s insured mortgages through the Federal Housing Administration (FHA) which allowed savings and loans to take on a little more mortgage risk in their lending portfolios. The Federal Home Loan Bank system provided short-term credit with subsidized interest rates to mortgage lending institutions. The creation of the Federal National Mortgage Association — known today as Fannie Mae — allowed lenders to sell their mortgages to the federal government and instantly replenish their capital which could be in turn loaned to someone else.

By the 1960s, suburbanization and the policies that accompanied its growth had changed American politics and culture. Many presidential speeches since then have included some kind of nod to the perceived importance of owning a home and have been often accompanied by a variety of new policies. By the late 20th century, owning a home was equated in the popular imagination as an important life goal.

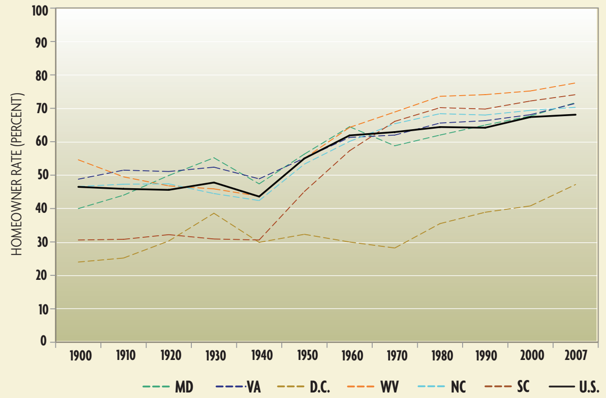
Today, the consequences of these trends are not something most people would like to ponder over their burgers at a suburban backyard cookout. But the consensus among economists now is that the policies geared to encouraging people to own homes have had very real economic costs.

Subsidizing the Homeowner

The favoritism showered upon home purchases by the government for at least the past 60 years has, in the aggregate, made it cheaper for people to borrow to invest in homes rather than other items. Thus, it should be no surprise that people will spend more time and money pursuing homeownership — and that's what has economists concerned. "There probably are effects on the homeownership rate that come from the fact that, on average, it's less expensive to be a homeowner than it would be in the absence of current policies," says economist James Poterba of the Massachusetts Institute of Technology, the current head of the National Bureau of Economic Research.

A major element in the subsidization of homeownership is the ability of mortgage holders to write off their interest payments when they file their income taxes. This isn't a new policy or one originally aimed at mortgage holders. The deductibility of interest was, until 1986, a key feature of the income tax since its inception in 1913 — anyone who had to make interest payments on any sort of debt was able to deduct these expenses. Although it may have been an accidental subsidy of sorts it had real consequences. Economists Harvey Rosen of Princeton University and Kenneth Rosen of the University of California-Berkeley conclude that about one-quarter of the growth in the proportion of homeowners between World War II and 1980 was driven by this favorable tax treatment of mortgages.

Some economists quibble with this analysis. New research by Glaeser suggests that the decision to buy or rent may not really be influenced by the deduction. His study, co-authored with Harvard colleague Jesse Shapiro, suggests



SOURCE: U.S. Census Bureau

that the families who might be on the fence about buying a house are the least likely to take advantage of the deduction. "The bulk of the benefits," says Glaeser, "go to fairly rich people who aren't particularly close to the margin between owning and not owning. These are people who are overwhelmingly in single-family detached houses, and they would be likely to own that house with or without the home mortgage interest deduction."

But that doesn't mean that he thinks the subsidy is inconsequential. Instead, Glaeser says the deduction encourages people who were already planning to buy a home to add more things to their housing purchase wish-list. "It mainly serves to induce prosperous people to buy bigger homes and pay more for those homes," suggests Glaeser.

Other government subsidies are less obvious, but they also have the effect of actively steering more investment capital toward the housing market. Government loan guarantees through the FHA can generally lower the cost of having a mortgage — after all, if a banker knows the government will pay him back if a loan goes sour, he'll be less worried about the risks of lending and can charge a safe borrower a lower-risk premium (i.e., interest rate) or expand his lending portfolio to include higher-risk borrowers.

Then there are the benefits bestowed by the federal government for decades upon the government-sponsored enterprises (GSEs) Fannie Mae and the Federal Home Loan Mortgage Corporation, known more commonly as Freddie Mac. These include explicit benefits (like certain exemptions from the securities exchange laws that bind ordinary banks) and implicit ones (like the widely expected claim that the institutions had a credit lifeline financed by the U.S. Treasury — a perception that was reinforced when Fannie Mae and Freddie Mac were placed under conservatorship by the federal government in September). The ability of these GSEs to buy mortgages from banks and turn them into tradable securities also creates an incentive for banks to issue more mortgages. The Congressional Budget Office estimates that the combination of these subsidies has resulted in mortgage interest rates for borrowers that were up to a quarter percentage point lower relative to what they would have been otherwise.

The Downsides of Widespread Homeownership

Whether subsidies to homeowners encourage more home purchases or instead simply lead people to buy bigger houses may not matter much. What really matters is that both result in similar economic effects. As Poterba explains: "The general pattern has been that we have invested more in housing relative to other kinds of capital goods than we would in an economy in which the tax system and credit institutions did not tilt the playing field at all." Simply put, Americans may have overinvested in housing.

This has been a worry of economists for a while. It's a concern based on what they see when they compare the rates of return — profit per dollar invested — for a variety of capital types. Most studies look at two broad categories: housing capital and nonhousing fixed capital. The latter consists of investments in manufacturing plants, machinery, and other sorts of investments that produce goods. Economic theory suggests that the rates of return for each form of capital should equalize over time. That's because market forces would, all things being equal, allocate capital in such a way as to deplete the profit potential in this fixed set of investment options.

For instance, if an investor in one sector saw a higher rate of return elsewhere he would move his money into that other sector. But if enough people followed suit, the profits in the newly popular sector would drop. (Imagine a suburban strip mall with eight ice cream stores. You can see how difficult it would be for each of them to make the profit that they would if they were the only ice cream store in town.) As the investment flows away from the old sector, however, the rates of return there will rise again. At some point — what economists call "equilibrium" — the rates of return for both categories of capital would be the same.

But there is another element of housing that is unique: Buying a home is an investment made by people in a structure and in a community where they live. Perhaps there are other unmeasured benefits of housing investment above and beyond the simple rate of return. Some economists have suggested that housing investment creates a positive benefit (or "externality") for the people who live in a community composed predominantly of homeowners. Renters, as the logic goes, don't have much long-term interest in the property they inhabit. Homeowners, on the other hand, want the neighborhoods they live in to look good so you would expect them to pay more attention to how nice their property looks.

Some economists, like Ed Glaeser, have found that the main positive externality of home investment is the number of well-tended gardens in communities with a larger number of owners. This benefit could be expected to increase the aesthetic value of the community and could increase the attractiveness of the community to potential residents.

The most comprehensive studies — such as a 1998 paper published by the Federal Reserve Bank of Dallas — seek to include a measure of these sorts of externalities in their rate of return calculations. Yet, even then the conclusions suggest that Americans have overinvested in housing, relative to other nonhousing capital investment, since at least 1929.

"When you observe that the measurable rates of return are different across the sectors," said the Dallas Fed study author, Lori Taylor of Texas A&M University, "you either have to conclude that there are substantial unmeasured returns across the sectors or you have to conclude that society would be better off with a reallocation of resources." These unmeasured benefits would have to be very large — at least $3,600 per homeowner in America — for the investment imbalance to be explained. And even if you assume that the positive externalities are this large, there may be vastly better ways for the government to encourage the good behavior.

If the goal is for better-looking communities, why subsidize the purchase of the home? asks Glaeser. Instead, why not target the real cause of the community beautification? "You can target that," he says, "with a limited gardening subsidy, for instance. Give people who plant a garden a subsidy to buy mulch and leave it at that."

Instead, the current policies produce an economy in which housing investment is generally higher than it would be if government didn't favor it. And every dollar that is invested in housing stock is a dollar not invested in a more productive use elsewhere. That results in a net reduction in overall economic efficiency.

Nor is it clear that using a home purchase as a primary vehicle for a family's investment is sound financial advice. Robert Shiller, an economist at Yale University and an expert on national housing markets, has estimated that "from 1890 through 1990, the return on residential real estate was just about zero after inflation." Throw in the costs of maintenance of the property and it's easy to see how renting could certainly be cheaper than owning, even if you include the tax advantages. Yet the opportunity cost of those home investments — the foregone investment opportunities elsewhere — go largely unseen.

The costs of owning a home go beyond the financial commitments too. Being tied down to a house tends to make people less likely to leave an area in which employment prospects are deteriorating. After all, terminating a lease is much less costly and time-consuming than foreclosing on a house or selling a home, even if the owner breaks even on the transaction. Economists predict this would lead to a decline in "labor mobility," the ability for people to move to where the jobs are.

A seminal study by British economist Andrew Oswald of the University of Warwick traced the link between unemployment and homeownership. Oswald looked at the United States, the United Kingdom, France, Italy, and Sweden between 1960 and 1996 and discovered that, on average, a 10 percentage point increase in homeownership tended to correlate with a 2 percentage point increase in the unemployment rate.

Recent studies of European data discover that you don't see these sorts of correlations in areas with higher concentrations of renters. Renters are simply more able and willing to move away when their community hits the economic skids. In addition, workers who aren't likely to move from a specific location might create frictions in the markets for labor skills. It's a cost to the economy when people live in an area in which their skills are no longer valued. But there is a potential personal cost too: The overall welfare of that worker may suffer.

Homeownership also tends to contribute to adverse political incentives. Incumbent homeowners have an interest in keeping their property values high and have been shown statistically to have a bias in favor of land-use regulations. These restrictions limit the number of houses that can be built in any geographic area and, consequently, keep housing inventory low and property values artificially inflated.

None of this means that economists think the United States should become a nation of renters. Nor is it likely that would happen anyway. Getting rid of the government subsidies to home purchases probably wouldn't dent the homeownership rate much as long as people continue to prefer living in the suburbs (albeit it in slightly smaller homes) and the United States remains a wealthy country. Instead, the take-home message for policymakers, as Glaeser suggests, is that they should not aim to "increase homeownership at all costs." Unfortunately, it may have taken major adversity in the financial and housing markets for this alternative storyline to be considered seriously. **RF**

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