Praise Be to Government: But there is always Room for Improvement

Is the U.S. mortgage market a good example for a functioning public private partnership?

The U.S. is among the few developed nations that pursues a large and not strictly targeted public support program for the mortgage market. It consists essentially of two parts: generous income tax relief for homeowners that boost mortgage demand, and public guarantees and regulatory privileges that benefit the mortgage industry. The approach is unchanged since the New Deal era of the 1930s when it was designed to fight the Depression through construction-led growth and rescue a failing private mortgage industry.

The program must be credited with a number of spectacular successes, the three most important perhaps being a unique fixed-rate mortgage product protecting consumers from interest rate risk, a nationwide management mechanism for credit risk, and extended access to finance and thus homeownership for previously excluded parts of the population. However, 70 years after the program's inception the high current and contingent fiscal costs associated with it are a cause for concern and controversy. I argue that the time has come to launch a cost-benefit analysis that sets the scene for fundamental reform.

An initial review suggests that the Federal homeownership program must have a fiscal cost of approximately $200 billion per year, translating into subsidies of over $250 per homeowner per month. This is a rough approximation by the author; neither the Federal government nor Congress publishes sufficiently detailed reviews of housing subsidies. Moreover, an actuarial valuation of the credit guarantees is both technically difficult and – understandably – subject to controversy.

Clear figures are available for Federal income tax benefits, In this case, the Office of Management and Budget puts the housing component for 2003 at approximately $125 billion, including capital gains tax exemptions ($20.3 billion), property tax write-offs ($22.3 billion) and mortgage interest deductibility ($65.5 billion). Mortgage interest deductibility applies to individual loan balances under 1 million US$ and is currently the second largest Federal tax benefit after medical insurance and Medicare, significantly larger than the one for 401(k) retirement plans.

These tax benefits are critical. Since the revenues of homeowners in form of saved rent payments are not taxed in the US, the tax deductions are an asymmetric application of the investment good concept in taxation. That is why it is fair to characterize them as subsidies, despite the fact that local property taxes take away some of the advantage. Many European countries, including France, Germany and the U.K., have departed from the investment good concept in owner-occupied housing, because saved rent payments were impossible to tax administratively and politically, the in-built subsidy has benefitted upper middle and high income earners disproportionally, and its level became hard to control when property prices soared. All of this is true also for the U.S. In fact, income tax benefits can be deemed to be the main culprit for the strong and unequal growth in per capita housing consumption. Clearly, since the middle class would buy homes anyway during their lifecycle, or at worst would buy somewhat smaller homes, they do little to enhance the overall homeownership *rate*. Put in simple geographic terms, families in the rust belt, the corn belt, and other areas with both lower house prices and incomes, subsidize greater housing consumption of families in East Coast, West Coast and sun belt suburbia.

Central to the second large block of the program, credit guarantees are sacred in a country where the insurance program of the Federal Housing Administration, a Federal agency, created the modern mortgage market in 1934. Today, more than $3 trillion outstanding mortgages - 50% of the total and 30% of US GDP - are federally guaranteed. Of this total, only 620 billion US$ are targeted to low-income homeowners and protected by Federal agencies. The lion's share accrues to the middle class and is absorbed by the ‚government-sponsored' private enterprises Fannie Mae, Freddie Mac and the Federal Home Loan Banks, operating as wholesale mortgage banks and bond insurers. Government-sponsored institutions differ from agencies in one economically central aspect: they are *by construction* able to privatize profits and socialize the losses associated with the public guarantees of their liabilities.

In particular, Fannie Mae and Freddie Mac are among the most profitable financial institutions in the world, producing returns on equity between 20 and 25% p.a. GSE's internalize as profit one third of the annual costs of direct subsidies and indirect public credit support – according to Congress estimates, $13.6 billion p.a. in 2000 - while passing on only two thirds to middle and upper middle class homeowners. However, this figure – derived largely with the help of spread comparisons reflecting credit losses *expected* in the capital markets – does not reflect that *realized* credit losses may be much higher, depending on the likelihood of a severe financial and property market stress situation occurring. What matters is the financial construction, not actuarial precision: US taxpayers take the unlimited downside of the risk.

These contingent fiscal cost are exacerbated by abundant regulatory privileges, which add to the scale of potential losses. Although slow progress is being made, GSEs are still not subject to prudential financial regulation standards. This has led to a classical regulation arbitrage game in which for example an S&L can save capital costs by selling its mortgages to a GSE and repurchasing GSE insured MBS for the same amount. The result is not just that credit risk is implicitly transferred to government; also, market risk, a key driver of the crisis of the 1980s, stays with the S&L. Even more disturbing, US regulations have disconnected from a central common sense theorem of financial regulation: risk partition through limitation of large exposure. Derogations in National Banking Act as well as state insurance and pension fund legislation allow financial institutions to hold almost limitless exposures in GSE securities. This fuels the growth of Fannie Mae and Freddie Mac, huge institutions that today are almost impossible to contest both economically and politically. Decades of political indulgence have helped to create a market structure that, for any given likelihood of a crisis occurring, maximizes the likelihood of a public bailout and consequently follow-up cost for taxpayers.

How do these costs compare to the benefits they create? Firstly, there is the fixed rate mortgage contract with prepayment option. Prepayment is a built-in stabilizer that serves to reduce housing costs at a time when interest rates fall, as they usually do during recessions. Offering the option requires some form of initial public support since capital markets under volatile conditions fail to deliver it at prices acceptable to consumers. Is permanent fiscal support justified to protect the product? Probably, not. Are there less expensive alternatives that would be fiscally more consistent without overburdening consumers ? Certainly, for example interest rate protection schemes for low-income borrowers. Secondly, in a large country such as the US, credit risk management should in fact exploit regional diversification effects. But here the dog bites its tail: it was the regionally separated banking system that spurred the creation of Fannie Mae in 1938. Countries with less fragmented histories of banking regulation have, at an early stage, developed private mortgage banks that operate nationwide and have proved to be able to deliver the job. Finally, affordable housing. Few would argue that the GSE system *today* produces as much of a contribution to housing policy as it did *back in the mid-20th century,* when low-income mortgage finance was an emerging industry. Rather, the combination of tax relief and industry subsidies must be held to have bid up land prices and crowded out urban low-income households, who according to Harvard’s annual review of the US housing sector shoulder exorbitant rent or debt service to income ratios. Targeted cash subsidies and guarantees - both currently under political pressure - are a better way to enhance housing affordability in the low-income population segments. So would be a deeper private rental market, especially for the young and the mobile.

In my view, given the blossoming financial services industry in the US, measures aimed at strengthening competition in the wholesale mortgage market, reducing Federal tax benefits and guarantee costs and shifting program focus to low-income households could produce substantial efficiency gains without compromising housing policy goals.

An alternative housing program could abolish tax preferences. It could then start rebuilding by developing a safety net for defaulting homeowners – the route the UK has taken – and grant-like subsidy schemes to help those at the threshold to buy – the German/French approach. Guarantee programs could be continued, but they should be targeted and properly regulated, observing the key condition that the downside risk for taxpayers is strictly limited. Finally, the mortgage industry should, like other financial services industries be subjected to internationally accepted, prudential financial regulation, ending a century of unjustified and costly special treatment.

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