It is unclear whether the United States should continue to subsidize the purchase of homes. While U.S. subsidies may have helped expand homeownership, they also may have made the economy more susceptible to shocks and more prone to sluggish recovery, as well as led households and financial institutions to take on risks that can jeopardize the economy at large.

**KEY POINTS**

- The benefits of homeownership are likely overstated, and widespread homeownership may increase the economy’s vulnerability to shocks.
- Indirect homeownership subsidies through the government-sponsored enterprises (GSEs) have arguably encouraged greater risk-taking in mortgage markets at taxpayer expense. Many of the benefits have not been passed on to lower-income households.
- Withdrawing GSE subsidies could raise the cost of the popular 30-year, fixed-rate mortgage, but it is not clear that this effect would be large.
- The mortgage interest tax deduction likely has benefited wealthy households most. Moreover, research suggests that it encourages people to purchase larger homes than they already were planning to buy, rather than encouraging greater homeownership.
- If the United States continues to pursue homeownership subsidies, policymakers should consider efforts that subsidize the accumulation of housing equity rather than housing debt, as has been done in other countries.

**DISCUSSION**

The U.S. government has a century-long history of promoting homeownership through direct subsidies to households and indirect subsidies through mortgage markets. (For a brief history, see Slivinski 2008.) The United States subsidizes homeownership far more than any other developed country. This policy stance has been questioned rigorously after the events of recent years. House prices boomed during the early 2000s followed by a reversal of historic proportions starting in 2006. This led to a wave of delinquencies and foreclosures and a related financial crisis in 2007–08. For millions of people, homeownership has not paid off. Moreover, research suggests that the housing crash harmed the broader economy.

This essay provides a framework for addressing two key questions regarding housing finance policy: Should the government subsidize homeownership, and if so, how?

**Should the Government Subsidize Homeownership?**

Economists argue that government subsidies must pass one of two litmus tests. One determines whether positive “externalities” are present — that is, do the subsidized actions have beneficial side effects on other parties not directly involved? If so, a subsidy creates an incentive for people to take more of these actions, making society as a whole better off. (Similarly, taxes can offset negative externalities.) The second test determines
whether society wishes to redistribute resources to assist certain groups, in this case to expand access to owner-occupied housing.

Substantial effort has gone into measuring positive externalities to housing. Many studies have documented, for example, that neighborhoods with a large proportion of owner-occupied homes tend to have better upkeep, higher-performing schools, lower crime, and greater civic involvement. (The National Association of Realtors provided a summary in 2012.) However, it is difficult to say with certainty that homeownership created these benefits. Individuals who are likely to purchase homes may have innate characteristics that make them more likely to invest in their communities in other ways. People induced through policy to enter homeownership might not share these characteristics. Moreover, one would need to target a subsidy directly at the activity producing the positive externality to experience the positive effects. Recent work, for example, finds that efforts to improve properties can increase the value of surrounding properties (Owens, Rossi-Hansberg, and Sarte 2010). However, the approach of the United States has been to subsidize homeownership rather than improvements in housing quality.

Instead, there is evidence that homeownership may come with negative externalities. Homeownership could affect the labor market, for example, particularly when house prices decline. Homeownership makes it harder to relocate since selling a home entails significant transaction costs. This could lock people into one geographic location, which could affect the health of the local job market by, for example, making it costly for firms to find the right mix of workers. As a result, unemployment rates might increase as firms find their searches for employees are less effective and post fewer vacancies. In fact, research suggests that U.S. states with high homeownership have much higher unemployment rates in the long run, possibly due to lower labor mobility (Blanchflower and Oswald 2013). The cost of low mobility could rise during an economic downturn, when job opportunities are scarce, yet this is precisely when mobility is likely to decline because house prices become more likely to fall or remain low. Following the recent housing downturn, a record number of homeowners — as a many as a quarter, by some estimates — had negative equity in their homes (they owed more on the mortgage than the home was worth), a situation that may force a homeowner to accept a loss in order to sell. Households with negative equity are 30 percent less likely than other homeowners to relocate, according to one study (Ferreira, Gyourko, and Tracy 2012). In the initial years of the downturn, states with the greatest incidence of negative equity experienced greater declines in residential mobility (Caldera Sánchez and Andrews 2011). Low labor mobility — which could be exacerbated if homeownership subsidies result in an underdeveloped rental market — also prevents workers from moving to jobs where they are more productive. Thus, the inability or unwillingness of some households to relocate, even when sensible for them individually, may impede the recovery of the overall labor market from a recession, thereby limiting opportunities for other workers.

To be sure, the evidence is not conclusive on whether negative equity has contributed to the high unemployment rates of recent years. For example, recent theoretical research has found that a decline in house prices has only a moderate effect on the aggregate unemployment rate, though it reduces migration and causes unemployment to rise by different degrees in different locations (Karahan and Rhee 2013). Widespread homeownership also can reduce consumer spending if house prices fall. Owner-occupied housing typically is the largest single asset in a homeowner’s investment portfolio. While households can diversify their financial investments relatively easily — for example, by holding an indexed security that tracks the overall market — there are relatively few ways for average homeowners to protect their portfolios against the risk that the value of their houses will fall. Though aggregate house prices don’t decline often, local house prices are much more volatile, especially in large coastal cities. Thus, housing subsidies encourage households to adopt a risky investment strategy. Again, an individual household may decide that the benefits of homeownership outweigh these risks. But when many households have undiversified portfolios centered on housing, a widespread decline in house prices could harm the broader economy through potentially steep declines in wealth, which may lead to declines in household spending and overall employment. For example, a San Francisco Fed study shows that developed nations that experienced greater increases in household leverage during the housing boom of the early 2000s experienced faster house price appreciation and larger subsequent declines in
household consumption following the housing bust, a phenomenon that other research has found to also exist across states (Glick and Lansing 2010).

Note the distinction between the effects that subsidizing homeownership has on individual households versus the economy as a whole. By definition, a subsidy makes the recipient better off. With or without a subsidy, individuals may willingly accept the risks of homeownership in exchange for the private benefits. The relevant question for policymakers is whether the private decision to own a home imposes negative externalities on the broader economy. And the evidence suggests that high rates of homeownership make the economy more susceptible to shocks and more prone to sluggish recovery. Overall, the externality-based case for subsidizing homeownership does not seem strong. It seems likely instead that subsidies for homeownership are motivated by distributional goals.

What Is the Best Way to Subsidize Homeownership?

In the United States, subsidies to housing finance take two dominant forms.

- Indirect subsidies through the mortgage market, most notably through the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac; and
- Direct-to-consumer incentives, most notably through tax deductions that homeowners can claim for mortgage interest payments on owner-occupied homes.

There is evidence that each of these avenues has had unintended effects, while failing to benefit targeted groups as much as hoped.

**The GSEs**

Since their creation as private entities in 1968 and 1970, respectively, Fannie Mae and Freddie Mac have existed to make mortgages cheaper and more widely available. With the mortgages they buy, the GSEs create and guarantee mortgage-backed securities (MBS), some of which they hold as investments and some of which they sell to investors. Empirical studies have found that the actions of the GSEs have tended to push down interest rates on mortgages that are eligible for GSE purchase, although this doesn’t seem to explain the entire spread between eligible mortgages and other mortgages (Passmore, Sherlund, and Burgess 2005).

In large part because of the GSEs, the government’s role in housing finance was large before the recent crisis. At their pre-crisis peak in 2003, the two GSEs purchased half of all new mortgages. Their role grew even larger following the housing bust. According to the Federal Housing Finance Agency (FHFA), the GSEs’ regulator, the GSEs issued $488 billion or 69 percent of all MBS volume in the first nine months of 2014 (an additional 30 percent of the total volume was issued by Ginnie Mae, another quasi-governmental entity).

GSEs raise funds by issuing debt. Though the GSEs are private corporations, markets have, for decades, widely expected that the government would provide the GSEs with emergency funding in the event of financial trouble arising from the need to repay debt. This implicit support gives creditors good reason to expect repayment. As a result, investors have been willing to lend to Fannie Mae and Freddie Mac at lower interest rates than most other corporations, which has helped them remain bigger than they otherwise would be. This also has hindered the ability of private mortgage institutions to compete.

The expectation of government backing was proven correct in September 2008, when the GSEs were placed into federal conservatorship to prevent them from failing. Conservatorship means the GSEs’ operations were allowed to continue under government control with large financial support from the government and with the FHFA responsible for allocating losses among the GSEs’ creditors. The government remains in this role today. (See Federal Housing Finance Agency: Conservatorship.) Thus, the extraordinary role that the GSEs currently play in the mortgage market is entirely dependent on taxpayer support.

The government’s implicit subsidy to the GSEs arguably led to increased risk-taking in mortgage markets (Lacker 2011). With an assumed government backstop, the GSEs and the investors that funded them had reduced incentive to ensure that the mortgages they financed could withstand a nationwide decline in house prices. Given the large impact of GSE activities on the U.S. housing market, the GSEs’ bias toward risk helped to similarly distort the incentives of other housing market participants. These risks were spread throughout the financial system as mortgage-backed securities were traded, repackaged, and resold among investors worldwide. The Richmond Fed argues that the government’s implicit financial safety net was a key component of the financial crisis of 2007–08. (See...
Federal Reserve Bank of Richmond, “Our Perspective: Too Big to Fail.”

U.S. taxpayers fund these risks. Richmond Fed researchers estimate that at the end of 2016, Fannie Mae and Freddie Mac constituted one-fifth of the total federal financial safety net, which itself covers 60 percent of the entire financial sector (Marshall, Pellerin, and Walter 2017). Under conservatorship, taxpayers have purchased more than $187.5 billion in GSE stock, and the Treasury has agreed to provide up to $274 billion in additional capital if necessary under the most recently amended conservatorship agreement.

Before conservatorship, the government’s support of the GSEs was implicit, meaning it did not appear on congressionally approved budgets. Since the GSEs’ September 2008 conservatorship, the government’s support of the GSEs is now arguably explicit (Marshall, Pellerin, and Walter 2017). Although the assistance given to the GSEs since September 2008 does appear in the federal budget, federal financial statements do not reflect the government’s total exposure to GSE liabilities. If the full scope of the GSE safety net were made more visible, taxpayers might very well view its size as unacceptable. The combined liabilities of Fannie Mae and Freddie Mac were $5.2 trillion as of December 2014, roughly 40 percent of the amount of outstanding U.S. Treasury debt held by the public.

Meanwhile, not all the gains of taxpayer support to the GSEs have accrued to homeowners. Economist Wayne Passmore of the Federal Reserve Board of Governors estimated the market value of the GSE subsidy to be between $122 billion and $182 billion (Passmore 2005). He concludes that more than half of those gains likely are retained by GSE shareholders rather than passed through to homebuyers in the form of more affordable mortgage financing, though other estimates vary.

One common argument in favor of the GSEs is that removing mortgages from the balance sheets of mortgage lenders enables those lenders to offer 30-year, fixed-rate mortgages, which are generally viewed as popular and consumer-friendly. Historically, branching restrictions on banks made it difficult for them to diversify, so the GSEs offered a way to help banks offload geographically concentrated risks as well as interest rate risk. Since branching restrictions were lifted in 1994, the GSEs now mainly provide relief from interest rate risk, and their comparative advantage relative to private investors in doing so stems from the implicit government subsidy. Thus, if the function of the GSEs were to go away, the 30-year, fixed-rate mortgage could become more expensive, reflecting the removal of the government’s implicit subsidy. At the same time, given the findings of Passmore and others that much of the subsidy has not been passed on to homeowners, it is not clear whether that effect would be large. It is also worth noting that the average duration of homeownership is much shorter than 30 years, so a mortgage of that term may unnecessarily increase the cost of the loan. The vast majority of other developed nations rely on mortgages of much shorter duration, often with adjustable interest rates and often with higher homeownership rates than the United States (Haltom 2011).

The GSEs have not been reformed since the recent crisis, so the problems caused by their implicit subsidy, which is now arguably explicit, remain intact. However, there is a consensus among policymakers — illustrated by a February 2011 proposal from the U.S. Treasury and the Department of Housing and Urban Development (U.S. Treasury and HUD 2011) — that at least some of the support the GSEs provide to the housing market must be unwound, potentially by dissolving Fannie Mae and Freddie Mac. A key principle of these discussions has been that private capital must undertake a larger role in housing finance, which is only possible by unwinding the government subsidy.

In the Richmond Fed’s view, limiting or eliminating the type of subsidy that the GSEs provide to mortgage finance would be the most effective way to ensure a stable market for home mortgages. Many existing reform proposals, even if they significantly wind down or dissolve the GSEs, retain a role for government guarantees to promote affordable housing. (For a recent example, see a February 2013 report produced by the Bipartisan Policy Center.) As reform proceeds, a key risk is that an entity or function could emerge in place of the GSEs, that is, one that similarly enjoys the market perception that it would be rescued in the event of failure. Policymakers should work to prevent these expectations from arising. To the extent that the government continues to support housing finance, the terms should be made explicit: Firms receiving support should be charged premiums to offset the subsidy provided to them, and they should be regulated appropriately (Lacker and Weinberg 2010).
Direct Subsidies to Homeowners

There is somewhat less consensus about how to reform other aspects of housing policy. The federal government has a long history of supplying direct-to-consumer support of housing finance, most notably in the form of favorable tax treatment of owner-occupied housing investments relative to financial investments. A key example is the mortgage interest tax deduction, which has existed since 1913 and was strengthened in the mid-1980s. The president’s 2016 budget estimates that this benefit will cost the government $69.5 billion in 2015 and become the government’s second largest category of income tax expenditures over the coming decade.

A common argument in favor of homeownership, especially for lower-income households, is that it promotes wealth-building since households can build equity by making monthly mortgage payments. However, most of the government’s policies, especially the deductibility of mortgage interest, subsidize the accumulation of housing debt rather than equity. This creates risks to the broader economy, as described above.

The mortgage interest tax deduction also has led to unintended distributional effects. The deduction is regressive in nature since wealthier households are more likely to itemize their tax deductions. The wealthy are also more likely to have larger homes and, consequently, larger mortgage interest payments to deduct. In 2006, households in the lowest 60 percent of the income distribution received 3 percent of the mortgage interest deduction benefits, while the top 20 percent of filers received more than 80 percent (Gale, Gruber, and Stephens-Davidowitz 2007). In addition, theoretical (Cho and Francis 2011) and empirical research (Glaeser and Shapiro 2002) suggest that the mortgage interest deduction doesn’t have a large effect on homeownership rates. These findings, combined with the fact that most of the gains from the mortgage interest deduction go to higher-income households, suggest that the tax benefits tend to go to individuals who were already willing to buy a home. In other words, rather than pushing households into homeownership, the mortgage interest deduction may simply encourage people to purchase larger homes than they already were planning to buy.

A better strategy might be to encourage the accumulation of home equity through tax-preferred savings vehicles that could be used for making down payments. Other developed countries have had success with savings programs (Haltom 2011) that provide households with the incentive and means to build equity, hence creating better conditions for the beneficial spillover effects of homeownership. Greater equity also reduces the likelihood of negative equity when house prices fall, thus better insulating the broader economy from house price changes.

Conclusion

In the Richmond Fed’s view, it is not clear that the United States should continue to devote substantial resources toward subsidizing homeownership. Promoting homeownership, especially in the ways currently done, appears to have the potential for substantially misallocating resources and making the overall economy less resilient.

Expanding homeownership may be a goal with widespread societal support, but many of the resources historically devoted to it have benefited unintended groups. Methods that subsidize housing equity, instead, may be more successful at helping lower-income groups achieve homeownership in a way that promotes greater stability of the housing market.

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