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Subsidizing Home Buying: Could Be Worse

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Last week the Senate embraced a $15,000 homebuyer's tax credit, while the plan to give every American access to 4 percent mortgages appears to have fallen by the wayside. If they had to choose one — and personally, I would have recommended neither — the Senate certainly made the right choice. A short-term tax credit is likely to do far less harm than another open-ended interest subsidy program.

The homebuyer's tax credit allows homebuyers to reduce their taxes by 10 percent of the price of their new home up to $15,000. While taxpayers have the option of spreading the credit over two years, the house must be bought in 2009. One of my favorite features of the program is that it explicitly ends one year after it becomes law.

Why does the tax credit make more sense than an interest-rate subsidy? The benefits of either intervention, if any, are likely to be slight. The big difference between the two policies lies in their costs.

The homebuyer's tax credit involves a one-year reduction in tax revenues that is commonly being estimated at $35 billion. Given our current sales rate of about five million homes per year, I would have expected a number closer to $50 billion. However, relative to the unpredictable costs of subsidized interest rates, this level of uncertainty is quite modest.

One of the great problems with any interest rate subsidy program is that costs accrue only over time, and initially reside off-balance-sheet. Remember the old fiction that Fannie Mae and Freddie Mac were providing a service to homebuyers at no cost to the government? Some proponents of interest-rate subsidies even suggest that as long as the subsidized lending rate is higher than the current Treasury rate, the government is actually making money off the deal. Such logic conveniently forgets default risks and other costs. Financing trillions of dollars of mortgages would require the government to borrow trillions, pushing interest rates up and raising the cost of the national debt. Borrowing to bet is generally not a good financial strategy for governments.

Standard economic reasoning tells us that if the market has priced 30-year mortgages appropriately, so that their rates reflects default risks and other costs, then the gap between the market rate and the subsidized rate reflects the cost of an interest rate subsidy program.

Current mortgage rates are about 5.35 percent, which is 135 basis points above one proposed subsidized rate. Americans today have about $10 trillion worth of mortgages. If everyone refinanced into the subsidized rate, this would mean an ongoing annual subsidy starting at $135 billion a year, which would last as long as the mortgages do. The great virtue of the tax credit over the interest rate subsidy is that a one-time cost of $35 billion or $50 billion is a lot less than a perpetual annual subsidy stream.

The tax credit has other virtues relative to the interest-rate subsidy. It does not encourage people to borrow as much as possible. In the wake of the current housing collapse, it is hard to see the sense of subsidizing people to leverage themselves to the hilt to bet on housing. Mortgage subsidies flow disproportionately to the wealthiest Americans who buy the biggest homes and borrow most to finance them. The tax credit will still favor people buying expensive homes, but only up to $150,000. This is far fairer.

What will the effects of the $15,000 tax credit be? People will certainly try to get their home purchases in before the end of the year, at least if the 1975 homebuyer's tax credit is any guide.

The 1975 homebuyer's tax credit, the model for this bill, was aimed entirely at new homes. Between February 1975, before the announcement of the bill, and May 1975, when the bill's provisions were clear, the seasonally adjusted annual rate of new-home sales
increased by 150,000 units. The tax credit ended at the end of 1975, and the seasonally adjusted annual rate of new home sales declined by 66,000 units between December 1975 and January 1976. Given this precedent, the bill's proponents are right to suggest that the bill will increase the level of sales activity in the housing market during 2009.

Of course, extra sales activity isn't necessarily a plus. The current credit encourages extra churning of the housing stock, and arrangements where two homeowners sell their homes to each other next year only to flip them back the year afterward. That feature of the tax credit could be eliminated if benefits went only to buyers who purchase new or foreclosed homes.

Will the bill do much to increase housing prices? The 1975 tax credit provides little guidance.

Real housing prices continued to fall throughout 1975, and picked up only when the tax credit had run its course. The fact that the tax credit had little impact on prices isn't surprising. Back in those days, lawmakers thought that it was a bad thing if homes got more expensive for ordinary Americans. The 1975 credit was designed so that the seller had to verify that the sale price of the home was the lowest price at which the home had ever been offered. (The rule was later adjusted so that the home-sale price was capped at the listing price of February 1975.)

Standard economics suggests that a temporary $15,000 tax credit can, at most, increase prices by $15,000, and will probably have much less of an effect than that. In places like Las Vegas and Phoenix, prices will be determined by the essentially unconstrained supply of new homes. In places like New York and San Francisco, the value of the tax credit will be swamped by the other forces buffeting the economy. Everywhere, homebuyers are constrained by their need to come up with a 20 percent down payment. If the tax credit temporarily increased prices by $7,500, which would seem like a generous estimate, this will do little to stem the wave of foreclosures or increase the value of all those toxic mortgage-backed securities.

The government shouldn't be in the business of trying to inflate housing prices artificially. As I've discussed here before, pushing up prices just reduces affordability and promotes more overbuilding. But if the government is going to intervene, then the homebuyer's tax credit is far preferable to more subsidized borrowing.

In fact, this Thursday, at a conference at New York University's Furman Center on rethinking federal housing policy, I'm going to argue that a tax credit of this form would be a much fairer and more efficient means of promoting homeownership than the home mortgage-interest deduction. I'll return to that topic in a later post.