The Role of Government in Promoting Homeownership: The U.S. Experience

By Gordon H. Sellon, Jr.

This conference has offered a unique opportunity for a wide-ranging exchange of views on housing finance. Yesterday's sessions provided a comparative view of housing finance systems and emphasized the importance of housing finance reform to the economic development plans of Central and Eastern European countries. This session of the conference focuses on philosophies of housing finance or, more specifically, on the goals and objectives of a housing finance system.

The issue I would like to address today is the role of the government vis-a-vis the market in a housing finance system. Since the potential scope for government involvement in housing is rather large, I will confine my discussion to policies designed to promote homeownership.

In many Eastern and Central European countries, housing has been viewed as a right, that is, as part of the social responsibility of the government. In contrast, a market-oriented approach would view housing as a consumer good to be provided by the market without government interference. Thus, an important part of housing reform in Eastern and Central Europe is a decision about the appropriate balance between government and the market in housing finance.

One approach to this problem is to look at how other countries have resolved this issue. Today, I would like to discuss the balance between the market and the government in the U.S. system of housing finance. The United States is particularly interesting because, while the market makes basic decisions about prices and quantities, the government attempts to alter these decisions through taxes and subsidies designed to increase homeownership. In explaining the large role of the government in U.S. housing

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finance, I will argue that most government programs are not designed to overcome limitations of the market mechanism, but rather, are largely a response to a highly artificial and inefficient structure of financial regulation. Thus, I believe that with a more rational system of financial regulation, the government's role in U.S. housing finance could be substantially reduced.

The paper is divided into three parts. The first section examines the rationale for a governmental role in promoting homeownership in the U.S. system of housing finance. The second section describes the main types of policies used in the United States and how they work. The final section discusses how the U.S. experience may be relevant to housing finance reforms in other countries.

What is the Rationale for Government Policies Promoting Homeownership?

There are two general arguments for a governmental role in promoting homeownership. A traditional view is that the market, left to itself, may not produce either an economically efficient or a socially acceptable level of homeownership. A somewhat different view advanced in this paper is that the system of financial regulation may bias the amount of homeownership below levels normally provided by the market. In the United States, I believe this second view provides more insight into the government's large role in housing finance.

Limitations of the market

The key feature of the market mechanism is that consumer goods are allocated on the basis of preferences and ability to pay. In the case of housing, homeownership will be achieved by those who desire to be homeowners and who have the necessary income and wealth.

A traditional economic argument for government intervention in a market is based on an imperfection in the market. This imperfection may result from an externality in production or consumption or from the characteristics of a public good. In these cases, the market may not produce an economically efficient amount of a good, and government actions in the form of taxes or subsidies may be appropriate to move the market closer to an economically efficient level of operation.

In housing finance, I believe it is difficult to identify a natural market imperfection that would lead to an economically inefficient level of homeownership. Thus, it is hard to justify government policies promoting homeownership on strictly economic grounds.[1]

One can make the argument, however, that the market will tend to produce a socially or politically unacceptable level of homeownership. A feature of homeownership is that it is extremely expensive relative to other consumer goods. The purchase of a home requires money for a downpayment plus income sufficient to cover interest and principal payments. Depending on the distribution of income in society, the market may tend to produce a relatively low level of homeownership. If homeownership is socially and politically desirable, government actions may be required to supplement the market mechanism.

In the United States, I think it follows from this discussion that there is no good economic argument for promoting homeownership. The social or political explanation is plausible, but, in my opinion, plays a secondary role to an explanation based on regulatory bias.

Regulatory bias

Markets are rarely allowed to operate freely. Most countries have elaborate systems of financial regulation designed to promote such goals as economic stability, the value of the currency, and consumer protection.

In the United States, much of the system of financial regulation dates back to the Great Depression in the 1930s. While much of this legislation was modified or dismantled in the last decade, I believe the evolution of housing policy in the United States has been strongly shaped by the regulatory structure of the 1930s. Specifically, I will argue that this regulatory structure was strongly detrimental to housing finance and homeownership.

During the 1930s, most changes in the structure of financial regulations were designed to stabilize and promote confidence in the financial system. Indeed, a number of authors have argued that these reforms promoted stability at the expense of competition (Huertas 1987). Yet, competition is an essential element in the market mechanism. Thus, to the extent that these regulations suppressed competition, they tended to impede the free flow of financial capital and so resulted in an inefficient allocation of financial resources.

I believe this regulatory system had particularly adverse effects on housing. To develop this point, I would like to examine three features of the 1930s system: geographic restrictions on financial intermediaries, product specialization of intermediaries, and development of a standardized mortgage contract. The net effect of these developments was to reduce the pool of investors who might fund housing, which lowered the flow of funds into housing and raised the cost of housing to consumers.

Geographic restrictions. The U.S. financial system has long been biased in favor of small, local deposit intermediaries. For example, such deposit intermediaries as banks and savings and loans have not been able to conduct full-scale deposit-taking and lending activities on a nationwide basis. These geographic restrictions have tended to limit the size of financial institutions and reduce the mobility of capital.

For many years funds for housing came primarily from deposits at local savings institutions. Because capital was not permitted to flow freely between regions, the cost and availability of housing finance varied considerably (Frederikson 1971). In particular, housing tended to be underprovided in rapidly growing regions with strong housing demand.

Functional specialization. Historically, financial institutions in the United States developed along functional lines. For example, commercial banks tended to specialize in business loans, while savings and loan associations and mutual savings banks provided housing loans. This historical development became the basis for a regulatory specialization in the 1930s, as financial institutions were restricted in the products they provided (Huertas 1987).

These regulations, like the geographic restrictions, impeded the flow of financial capital. Thus, housing was very dependent on the flow of funds into institutions specializing in housing finance. Because housing institutions competed with other local institutions for deposits, any competitive advantage of other institutions in attracting deposits led to reduced funding for housing, higher housing costs, and reduced homeownership.

Standardized mortgage contract. Beginning in the 1930s, the government promoted the use of a single, standardized mortgage contract. The key features of this contract were a long maturity (20 to 30 years), a fixed interest rate, and the ability of the borrower to cancel or prepay the mortgage on demand. These features were designed to be favorable to the borrower and so tended to stimulate housing demand. At the same time, the rigid terms of the contract made mortgages inherently unattractive to many investors. Those investors who wanted yields higher than deposit yields, short maturities, and certain cash flows would invest in corporate or government securities rather than in housing.[2]

The combined effect of these regulatory policies was to fragment capital markets and reduce competition. As a result, the allocation of funds to housing was reduced and the cost of housing increased. In this sense, I believe that financial regulations in the United States biased homeownership below market-determined levels and provided the impetus for government programs to stimulate homeownership.

Government Policies Promoting Homeownership

Since the 1930s, a great variety of government programs have served to increase homeownership in the United States. The overall effect of these programs has been to offset the negative impact on housing caused by the regulatory structure. Most of these policies work by increasing the flow of capital into housing markets or by directly reducing the cost of homeownership.

Actions to channel funds through the private sector

Government policies to encourage a greater flow of funds through private intermediaries fall into two categories: insurance guarantees and restrictions on investment options for small investors.

Two forms of insurance guarantees were introduced in the 1930s. *Deposit insurance* was originally designed to promote financial stability by increasing public confidence in banks and other deposit intermediaries. Under this program, investor deposits in eligible institutions were insured by the government up to a fixed dollar limit. *Mortgage insurance* was developed to make housing more affordable and to make mortgages more attractive to investors. Under this program, mortgages conforming to government guidelines were federally insured.

Deposit insurance had a stimulative effect on housing because deposits at savings and loans and other specialized housing intermediaries were generally insured. To the extent that investors valued the safety of investments in the deposit liabilities of these institutions relative to uninsured investments, the total flow of funds into housing increased. In addition, since these investors were willing to pay for this insurance through a reduced interest rate on deposits, savings institutions were able to pass on the lower cost of funds to homebuyers in the form of lower mortgage rates.

Mortgage insurance also stimulated housing. With government guarantees on mortgages, borrowers were able to reduce downpayments and pay a lower interest rate. Moreover, government guarantees made local mortgage loans from across the country attractive as investments to national financial intermediaries, such as insurance companies. Thus, mortgage insurance had the dual effect of overcoming geographic regulatory barriers and broadening the investor base.

One result of the 1930s regulatory structure was that housing was very susceptible to events that diverted deposits from savings institutions. That is, any competitive advantage of the deposits of non-housing intermediaries or other investments reduced the flow of funds into housing. For example, if banks could offer higher rates on deposits than savings institutions could or if investors could get higher yields from direct investments in capital markets, housing would tend to suffer.

To avoid these problems, a variety of government policies attempted to stabilize the flow of funds into savings institutions. The most significant program was a restriction on deposit rates that could be paid by commercial banks. These interest rate ceilings on bank deposits prevented banks from attracting funds away from savings institutions by offering higher rates. Another program restricted the minimum denomination of government treasury securities in an attempt to force small investors to place their funds in deposit intermediaries.

Creation of government-sponsored housing intermediaries

In addition to these programs, which increased the flow of funds through private housing intermediaries, the government has created a number of agencies to allocate additional funds to housing.

The Federal Home Loan Bank System (FHLBS) and the Federal National Mortgage Association (FNMA or "Fannie Mae") channel funds from capital markets into housing. The FHLBS operates by selling its own securities in capital markets and then lending funds to savings institutions to make more home mortgages. FNMA also sells its own securities and uses the proceeds to purchase mortgages from savings institutions and other mortgage originators.

Both of these government-sponsored agencies serve to overcome the regulatory barriers to housing finance discussed earlier. To the extent that these agencies are able to tap into national capital markets, they overcome geographic restrictions on the flow of housing funds. Also, because their debt securities have shorter maturities, more certain cash flows, and more marketability than mortgages, these securities broaden the class of investors and so overcome some of the limitations of the standardized mortgage contract.

More recently, FNMA, the Government National Mortgage Association (GNMA or "Ginnie Mae"), and the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac") have been the primary sponsors of the development of the secondary mortgage market. In this market, investors can purchase agency-guaranteed securities backed by pools of traditional mortgage loans. Like the earlier agency programs, the secondary mortgage market has greatly increased the flow of funds into housing by overcoming geographic regulatory barriers to capital flows and by broadening the investor base for housing finance (Sellon and VanNahmen 1988). The agency guarantees of the mortgage-backed securities also allow more favorable borrowing rates, which can be passed back to the homebuyer in lower mortgage rates.

Tax policy to increase homeownership

The tax system in the United States has also been used as a policy instrument to promote homeownership. Tax policy can offset higher housing costs caused by regulation either by increasing the supply of funds and reducing the cost of mortgage credit or by directly reducing the borrower's housing costs.

The most obvious use of tax policy to further homeownership in the United States is the deductibility of mortgage interest payments and the exclusion of imputed rental income from income taxes. This form of tax relief directly stimulates the demand for homeownership.

Tax policy has also been used to channel funds through institutions specializing in housing finance. For a number of years, thrift institutions that devoted a substantial portion of their investment portfolio to home mortgages received favorable income tax treatment. This policy encouraged savings institutions to specialize in housing finance and also resulted in lower mortgage costs to homeowners.

What Can Be Learned from the U.S. Experience?

I believe the U.S. experience sheds considerable light on the proper scope for government in housing finance. Such general issues as the interaction between housing and the regulatory structure, the merits of different types of housing subsidies, and the need for specialized housing intermediaries are relevant to other countries reassessing the role of government in housing finance.

Housing and financial regulation

The U.S. experience highlights the importance of a regulatory structure that is conducive to housing finance. Artificial restrictions on the structure and operations of financial institutions impede capital flows and reduce the efficiency of financial markets. In the United States, these restrictions have reduced the flow of funds into housing, raised housing costs, and led to political pressure for new housing programs.

The U.S. experience also illustrates the dangers of government standardization of financial contracts. It is highly unlikely that the market would naturally produce a single type of mortgage contract with characteristics similar to the long-term, fixed-rate mortgage common in the United States.[3] Such enforced standardization reduces the pool of investors willing to fund housing and promotes further government programs to offset the negative effects on private investors.

Types of housing subsidies

As discussed earlier, the United States has used a variety of techniques to subsidize housing, including restrictions on interest rates, insurance guarantees, and tax policy. I believe the U.S. experience suggests that tax policy is superior to the other types of subsidies.

The U.S. experience with direct interest rate controls has been particularly traumatic. Like other forms of direct price controls, interest rate ceilings, when effective, cause a serious distortion of capital flows.[4] In the United States, both the extended use of interest rate ceilings and their sudden removal in the early 1980s have caused periodic financial crises for savings institutions that have undermined the long-run commitment of these institutions to housing.

Insurance guarantees have become an increasingly popular form of government subsidy in the United States both in housing and other areas. Insurance guarantees have important advantages and disadvantages. On the positive side, insurance guarantees can significantly alter the behavior of borrowers and lenders without any current budgetary outlay by the government. On the negative side, however, these guarantees can significantly distort the risk-taking incentives of the private sector. Thus, they require considerable government supervision to limit the government's exposure to credit risk. The current savings and loan crisis in the United States is a testament both to the power of insurance guarantees and to the future budgetary exposure if these guarantees are not monitored.[5]

Of the three types of subsidies, I believe tax policy is the best choice. Like insurance guarantees, tax policy can be effective in attracting funds to housing. The important advantage of tax policy is that its budgetary costs are known, whereas the future budgetary impact of insurance guarantees is quite uncertain.

The role of specialized housing intermediaries

A final issue is the role for specialized housing intermediaries. In my opinion, the U.S. experience suggests that government-mandated specialization may harm rather than promote housing. Restrictions on product specialization reduce the flexibility of financial institutions in adapting to changing market conditions. In the United States, the housing specialization of savings institutions has made these institutions especially vulnerable to changes in competitive conditions. Moreover, the growth of government-sponsored housing agencies is largely the result of attempts to protect housing from the consequences of enforced specialization of private intermediaries.

This is not to suggest that specialized institutions cannot play a valuable role in housing finance. My point is that this specialization should be based on an underlying economic rationale as determined by the market rather than by government regulation.

Summary and Conclusions

This paper has examined the role the government plays in promoting homeownership in the United States. The central message of the paper is that the U.S. financial regulatory structure set up in the 1930s has adversely affected housing finance. As a consequence, many government housing programs in the United States can best be viewed as offsetting this regulatory bias rather than overcoming limitations of the market mechanism. It follows that had a more rational system of financial regulation been in place in the United States, the government's role in housing finance would probably have been much smaller. For other countries in the process of redefining the role of government in housing finance, this paper highlights the importance of setting up a financial system that promotes competitive forces and the free flow of financial capital.

Endnotes

1 For a more complete discussion of the rationale for government housing policies, see Richard Musgrave, "Policies of Housing Support: Rationale and Instruments," in *Housing in the Seventies*, 1976, pp. 215-33.

2 More recently, with periods of high inflation and volatile interest rates, the standard mortgage contract has proved unsatisfactory for both borrowers and lenders. For a discussion, see Patric Hendershott and Kevin Villani, (1977).

3 Indeed, with the financial deregulation of the early 1980s, a variety of new mortgage types have become popular.

4 This discussion focuses on deposit rate ceilings. There have also been ceilings on loan rates for government-insured loans and usury ceilings set by state law that have distorted capital flows.

5 Recently, in Congressional testimony, Secretary of Housing and Urban Development Kemp indicated that the government's primary mortgage insurance fund could run out of funds by the end of the decade due to increased default rates on government-insured mortgages.

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