IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

May 2, 2008 **Advisory No. 239**

THE SENATE'S MISGUIDED HOUSING BILL

On April 10, the Senate approved the "Foreclosure Prevention Act of 2008" (H.R. 3221) by an 85-15 margin. The proposed legislation is a package of tax and other incentives intended to assist the housing sector. Senator Max Baucus (D-MT), chairman of the Senate Finance Committee, described it as "help for home buyers, home-builders, and homeowners, and ... much needed support for the housing market" (*Congressional Record*, April 8, 2008, S. 2719).

This paper examines the main provisions in the bill and evaluates their likely economic consequences. Would they strengthen the housing sector, be ineffective, or actually hurt? More important would they help the troubled U.S. economy?

The paper also looks at two legislative proposals in the House of Representatives.

The economic situation

Before examining the bills in detail, it might be useful to review briefly the current mess in the economy and the housing market. The current economic weakness is due only in part to the bursting of the housing bubble, which has reduced construction spending. A broader source of economic weakness is a slowdown in investment across the board. A surge in capital formation and investment was triggered by the lowering of tax rates on capital in the 2003 Tax Act. That added capital formation has run its course. If we want a further round of capital growth, we need to further reduce the tax on capital. That requires not merely extending the 2003 tax cuts, but going beyond that, to reduce the corporate tax rate and make the "bonus" expensing provision of the recent stimulus bill permanent. And that is what the Congress should focus on.

In recent quarters, we have been relying on the Federal Reserve to prop up the general economy by sticking with easy credit and the rapid growth of bank reserves far longer than was wise. Inflationary signs are now appearing, in the form of a plunging dollar, soaring commodity prices, and upticks in the U.S. price indices (especially for food and fuel). Higher inflation will further depress investment by raising tax rates on capital, because capital consumption allowances (depreciation deductions) and capital gains are not adjusted for inflation. The excessive easing by the Federal Reserve cannot continue without doing serious economic damage to the U.S. and world economies, and to the role of the dollar as the primary international currency.

Housing market problems

An extraordinary housing bubble, during which home prices seemed only to rise and never fall, led to excessive investment in the housing sector relative to the rest of the economy. There were two contributing factors to the housing bubble. One was that the Fed kept monetary policy too easy for too long. The other was the invention of, and global credit market mania for, consolidated debt instruments (mortgage backed securities). Abnormally low interest rates courtesy of the Fed led

to soaring house prices that encouraged millions of people who could not afford expensive houses to speculate and become overextended, on the theory that they could always refinance at low rates and/or flip the house at a profit. The fat fees for extending additional mortgages and stuffing them into mortgage-backed securities led lenders to give credit to anyone who could put an X on a dotted line for almost any house, anywhere. Builders over-built, creating houses that were too large in size and in number for sale to too many people who could not afford them.

The bursting of the housing bubble hurt the economy by reducing housing construction. But its main adverse economic impact was the threat to the functioning of the financial system, that the defaults on mortgages and the unknown effect on the value of associated mortgage backed securities — consolidated debt instruments (CDIs) — might spread throughout the financial system and prevent ordinary lending between institutions and to businesses across the spectrum. The Federal Reserve has been dealing with that latter possibility by arranging a buy-out of Bear Stearns (the investment bank most heavily invested in the affected bonds) and by swapping liquid Treasury debt for illiquid CDIs.

The market is now rapidly correcting the excesses of the bubble. Housing prices are falling, which will improve home affordability. New home construction has declined, which will help work off the overhang of unsold properties and free more resources to be invested elsewhere in the economy. Lending standards have risen, and lenders are more cautious about accepting exotic, opaque debt instruments promising unusually high returns with supposedly little risk. The adjustments are painful, especially because the bubble was so large, but the economy would be permanently weaker if the adjustments were not made.

As will be discussed below, much of the legislation on Capitol Hill is crafted as though the problems were not the general weakness in investment and the bad decisions associated with the housing bubble but that the bubble eventually burst. The housing bill, unfortunately, is fixated on bailing out the builders and homeowners who took excessive risks. The bills would shovel more federal money into the housing sector, via tax provisions and explicit spending programs, to try to keep home prices closer to what they were at the peak of the speculative frenzy. Similarly, federal money would be used to attempt to prop up residential construction spending. To deal with affordability, the bills envision using federal programs so that certain households deemed worthy by the political process could stay in homes they cannot otherwise afford or buy homes at below-market prices. It would delay the necessary winding down of construction and home inventories, and would tend to keep people in houses they cannot realistically afford, and should not try to keep. Writing in the Wall Street Journal, Bruce Wasserstein said it would be as though the Dutch government had reacted to the collapse of the 17th century tulip bubble by trying to support tulip prices (Bruce Wasserstein, "What We've Learned From The Market Mess," *The Wall Street Journal*, April 10, 2008, p. A15).

Although such legislative proposals respond to the pain of selected constituents, they would create additional problems. If Congress prevents home prices from falling to a more normal level, fewer people who do not already own homes will be able to obtain them in the future. If Congress merely delays the fall in home prices, many potential homebuyers will stay on the sidelines until prices finally reach a market-clearing level, and in the meantime the inventory of unsold homes will climb higher than otherwise. Encouraging more residential construction at a time when the housing sector has been overbuilt relative to other parts of the economy would likewise be counterproductive. A further consideration is the cost to the federal budget and taxpayers of the proposed federal assistance. Far from strengthening the general economy, most housing proposals on Capitol Hill would further burden the economy and hold back the recovery.

The Senate bill's main provisions

The Senate bill contains four main housing-related tax elements. The largest provision, which Congress's Joint Committee on Taxation estimates would cost $6.1 billion over the next 11 years, would permit companies that lose money in 2008 or 2009 to carry the losses back 4 years, instead of the normal 2 years, to claim refunds against taxes previously paid. A second tax provision, with an estimated revenue cost of $1.7 billion, would temporarily expand the purposes for which state and local housing authorities may issue tax-exempt mortgage revenue bonds to include refinancing subprime mortgages and also would increase the total cap on tax-exempt mortgage revenue bonds by $10 billion in 2008. A third feature, with an estimated revenue cost of $1.6 billion, would give a $7,000 tax credit to people who buy homes in foreclosure in 2008. Another item would allow people who claim the standard deduction in 2008 to take, in addition, a special deduction of up to $500 ($1,000 for joint filers) for mortgage interest.

The Senate also tacked on $6 billion of tax credits for "clean energy" in an amendment unrelated to housing.

The bill contains many non-tax, housing-related provisions. Three of the largest will be mentioned here. One would give states and localities $4 billion in grants to buy abandoned or foreclosed homes. Another would permit the Federal Housing Administration (FHA) to insure higher-priced homes, with mortgages of up $550,000. The bill also includes $180 million to provide mortgage borrowers with credit counseling and legal service attorneys.

What the tax provisions would do

In general, the bill would provide more federal housing subsidies. The claim that this would bolster the economy rests on the assumptions that more aid is what the housing sector needs and that whatever is good for the housing sector is good for the economy. The bill does not include any recognition that prior federal aid and the housing bubble caused the housing sector to become too large relative to the rest of the economy, housing prices too high, and the number of homes too great relative to their affordability. Similarly, the bill does not recognize that the housing sector will only recover when a combination of lower home prices and a slower rate of new home construction bring the demand for homes back into balance with the supply.

<u>Longer net operating loss (NOL) carryback.</u> Current law generally allows businesses to carry losses two years back and twenty years forward to offset income in other years. The short carryback and long carryforward often force businesses with current NOLs to wait several years before they can use the losses to income average. This reduces the value of the offset, as the deferred losses are not adjusted for inflation, nor increased by any interest rate. By lengthening the NOL carryback to 4 years for 2008 and 2009 losses, the Senate proposal would speed up income averaging and permit more businesses with NOLs to promptly obtain refunds against income taxes they paid in earlier years. Given the time value of money, that would benefit the businesses. Of course, higher carrybacks now would mean lower carryforwards in the future, which is why the provision's estimated revenue cost is $25.5 billion through 2010 but only $6.1 billion through 2018.

The provision would provide cash at a time when businesses with less than sterling credit scores are having unusual difficulty obtaining funds. This would allow some businesses that are cash strapped by credit market turmoil but have good prospects to employ more workers, buy more materials, and make more investments than they otherwise could.

All businesses with NOLs in 2008 and 2009 would be eligible to participate, not just those in the housing and financial sectors. A provision available to businesses throughout the economy may also be more effective in strengthening the economy than one confined to a couple of sectors.

Tax-exempt mortgage refinancing bonds. This would essentially be federal aid, delivered through the tax system, to state and local programs that try to help financially-troubled home owners retain their properties and additionally try to stabilize home prices close to current levels. Unfortunately, many of the homebuyers who are now in trouble have such high mortgage payments relative to their incomes that helping them is likely to be very expensive per homeowner and, relative to other government programs, not a cost-effective use of funds. If the government tries to limit costs per household, many of the homeowners will still lose their homes, and the government aid will only drag out the problems for the overextended households and the housing market. Another concern is that although government housing programs would attempt to direct aid to deserving homebuyers, that is difficult to accomplish in practice. Along with deserving homebuyers, many of those receiving assistance would undoubtedly be people who bought homes to flip, purchased homes they could not afford in the expectation that constantly rising home prices would bail them out, lied about their incomes and assets to qualify for mortgages, took out second mortgages to finance consumer spending beyond their means, or in other ways acted imprudently for personal gain. Moreover, even if it is carefully authorized and administered, a government refinancing program may have the perverse effects of inducing some homeowners to stop making mortgage payments in order to qualify for the program and causing lenders to hold back on voluntarily renegotiating mortgage terms while they wait to see what sweeteners the government might offer.

Local governments have a self-interest in stabilizing home prices. Because property taxes are a major revenue source, rising housing prices bring gushers of money to city halls, and many local governments had planned their future spending on the assumption that property values and real estate taxes would climb rapidly forever. Notwithstanding the desires of homeowners and government tax collectors, it is obvious in retrospect that housing prices ascended so high and so quickly because of an epic asset bubble that has now burst. The proposed government mortgage refinancing program might slow the speed of the adjustment at a considerable budget cost, but home prices will continue falling until they reach a level consistent with economic fundamentals.

$7,000 tax credit to buyers of foreclosed homes in 2008. This provision presumably aims to stabilize home values. Certainly it would increase the attractiveness of foreclosed homes. Because of the tax credit, buyers would be willing to pay up to $7,000 more than otherwise. In effect, the $7,000 would be a government-funded gift to the buyers of homes in foreclosure and to the creditors owed money on those homes. Further, because of the 2008 deadline, some foreclosure sales would be accelerated from 2009 to 2008.

However, the tax credit would do nothing to increase the attractiveness of non-qualifying homes, that is, homes not in foreclosure (or not meeting various other conditions). If anything, the credit would depress prices for non-foreclosed homes, which would disadvantage the sellers of those homes, by making them relatively less attractive due to the lack of the credit. As an analogy, if the government offered a generous tax credit for purchases of repossessed cars, the credit would enable dealers to sell repossessed cars more quickly and for more money, but the credit would not make buyers any more eager to buy other cars. Therefore, if the credit is expected to stabilize home prices in general, it is certain to be a disappointment. Nor would the credit have an appreciable effect on the overall economy.

Special $500/$1,000 mortgage interest deduction for nonitemizers in 2008. This proposal may make sense as a way for elected officials to say, "We care," but it would have little relevance to current housing problems, and would not do much to assist the housing market or the economy.

People who have large mortgage payments usually already claim the mortgage interest

deduction: they have more than enough in interest costs, real estate taxes, and other expenses to make itemization attractive. Hence, a $500/$1,000 deduction for nonitemizers would mainly benefit people who have small mortgage payments, generally on old mortgages, that are not large financial burdens.

Moreover, because the standard deduction is supposedly claimed in lieu of itemized deductions, allowing nonitemizers to claim both a mortgage interest deduction and the standard deduction would essentially let them deduct the same expense twice. Many economists think that the tax system already has a bias in favor of residential investment at the expense of other types of investment. If so, this provision would slightly increase the bias, although the incentive effects would be almost negligible due to the provision's single-year duration and it's targeting of small, generally old mortgages.

<u>$6 billion of "clean energy" tax credits.</u> This provision has nothing to do with problems in the housing market. However, its supporters guessed correctly that the Senate would approve the housing bill, and they used the bill as a Christmas tree onto which to hang their tax credits. The House is reportedly less enthusiastic than the Senate about energy credits being in a housing bill. Ironically, by raising food costs, alternative corn-based fuels have worsened the housing market: higher energy bills are making it harder for homeowners to also pay for housing.

Effects of several of the larger non-tax provisions

<u>$4 billion for states and localities to acquire abandoned or foreclosed homes.</u> Under this section of the bill, state and local governments would have $4 billion of new federal money to acquire abandoned or foreclosed properties, provided the properties are then converted into low-cost housing, demolished, or used in certain other ways.

The policy assumption behind this proposal is that the government can better handle abandoned and foreclosed properties than the market. While government projects sometimes succeed and the prospect of more federal money is naturally attractive to local governments, the fact that many urban renewal projects and public housing projects have been spectacular failures creates uncertainty as to whether this would be a cost-effective federal spending program. The pace at which the grant money would be spent at the local level would almost certainly be too slow to offer any immediate help for housing or the overall economy. States and localities would have 18 months to spend the money after receiving it, and given the usual pace of government decision making, many would not act until the deadline approached.

The demolition option included in this provision is troubling. It is reminiscent of government programs in the 1930s that were supposed to revive the economy by plowing under crops and killing livestock to keep farm prices artificially. Those 1930s efforts did not bolster the economy, although they may have helped some in the farm sector, and they had the side-effect of destroying perfectly good food while people were going hungry. Similarly, it would be a waste of valuable resources if the government buys structurally sound homes and then demolishes them to reduce the number of foreclosed homes in the market. Demolition of an existing home should be reserved for cases in which the home is not fit for occupancy and cannot be fixed at a reasonable cost or in which the land can be put to a higher valued use. As for the argument that many abandoned and foreclosed homes should be torn down in areas with high foreclosure rates because they attract crime, better solutions are stepped up policing to reduce vandalism and greater reliance on

procedures like auctions that quickly move prices to levels at which buyers will come forward and the homes will be occupied.

Higher limit ($550,000) on the size of mortgages eligible for FHA insurance. Because the bipartisan stimulus bill signed in February increased the FHA mortgage cap for 2008, this provision would have its main effect in 2009 and beyond. Hence, it would not provide much immediate support to the housing market, and the aid it did furnish would mainly be at the high end for expensive homes.

When a mortgage carries FHA insurance, the government, which ultimately means the taxpayer, stands behind the loan if the borrower defaults. Due to the taxpayer guarantee, FHA loans carry lower interest rates than similar loans without FHA insurance. A higher FHA cap raises some public policy concerns. The people who take out mortgages above the old FHA limit typically have attained or can look forward to attaining much higher incomes and greater wealth than most taxpayers. Why should a government program force taxpayers to bear the default risk for borrowers who are relatively affluent (or at least consume like they are)? Another consideration is that a large insured mortgage puts more dollars at risk for the FHA and taxpayers than a small mortgage. For example, the FHA would be risking more dollars by insuring a single $550,000 mortgage than it would by insuring four $135,000 mortgages. As this example indicates, the proposed cap could sharply increase potential FHA losses. If Congress wants to limit taxpayers' risk exposure, it should let the FHA cap revert to its old level at the end of 2008.

Foreclosure counselors and legal aid attorneys. These elements of the bill are directed to the problems of financially troubled borrowers, and do not specifically focus on the broader housing market or the economy. Nevertheless, it is prudent to consider the broader effects. If foreclosure counselors and attorneys try to make sure that borrowers are dealt with fairly but recognize that borrowers have responsibilities and are realistic about their finances, they could improve communications between borrowers and lenders and facilitate the resolution of mortgage problems. (In hindsight, of course, the proposed counseling program would have been more useful to troubled homeowners and the economy if it had begun several years ago, at the start of the housing bubble, to warn people not to get in over their heads by buying more home than they could afford.) On the other hand, if the counselors and attorneys simply view lenders as the enemy, their presence would probably worsen and lengthen disruptions in the mortgage market and the economy.

The Rangel and Frank plans

There are many other proposals in Congress to inject more federal aid into the housing sector. Two of the most prominent are the Rangel and Frank bills.

Rep. Charles Rangel (D-NY) sheparded a bipartisan "Housing Assistance Tax Act of 2008" (H.R. 5720) through the House Ways and Means Committee. The bill would use the tax system to support the housing market, and its provisions bear some similarities to those in the Senate bill. It would temporarily expand the low-income housing tax credit, which would channel more loan money to that part of the housing market. It would increase the national cap on issues of tax-exempt mortgage revenue bonds by $10 billion in 2008. It would enhance the marketability of certain tax-exempt housing bonds by exempting them from the alternative minimum tax (AMT). It would provide a special mortgage-interest deduction (up to $300/$700) to homeowners who claim the standard deduction instead of itemizing. To encourage near-term home sales, it would temporarily give first-time homebuyers with incomes below certain levels a tax credit of up to $7,500, but require them to repay the credit over 15 years. The Rangel bill does not include any loss carryback provision. As with the Senate bill, it is not clear whether the provisions in the Rangel proposal would be cost effective or strengthen the overall economy.

Rep. Barney Frank (D-Mass), chairman of the House Financial Services Committee, steered the "FHA Housing Stabilization and Homeownership Retention Act of 2008" (H.R. 5830) through the House Financial Services Committee by a 46-21 margin on May 1. The centerpiece of this ambitious bill would be having the federal government assume responsibility, via FHA guarantees, for up to $300 billion of deeply troubled mortgages. To participate in the voluntary program, a mortgage lender would have agree to write down the loan principal to 85% of the residence's current appraised market value. The borrower would have to be heavily indebted, with a mortgage-debt-to-income ratio of at least 35%, and agree to share future home appreciation with the government. Certain other conditions would also apply. As this is written, it is being reported that the Frank bill will reach the House floor in a week or two.

Although the guarantee program would massively expand FHA insurance and sharply lower FHA underwriting standards, Rep. Frank contends it would cost the government very little because the lender write-down and the claim on future home appreciation would provide a sufficient cushion. He is also quoted as saying, "The more risk you take, then maybe the more good you can do." (Lori Montgomery, "Foreclosure Aid Hinges on Eligibility, How Many Are Helped," *Washington Post*, April 16, 2008, p. D01). Regrettably, he would be taking the risk with taxpayer dollars. Sen. Christopher Dodd (D-CT), chairman of the Senate Banking Committee, also likes the idea and plans soon to introduce a roughly similar bill in the Senate.

On the positive side, this proposal would allow private lenders to dump $300 billion of problem loans, albeit with a substantial haircut, which would lighten their risks and probably increase their willingness to make new loans. It would also sharply cut mortgage obligations for some heavily indebted homebuyers. Hence, the bill could aid many mortgage lenders and homebuyers in financial difficulty. Further, while taxpayers would be at risk because of the guarantee, they would be at more risk if not for the haircut.

On the negative side, the proposal would transfer to taxpayers the risk it lifted from lenders. Moreover, because lenders would only want to use this facility for mortgages whose expected, risk-adjusted value was below what the government would guarantee, the FHA would become a magnet for especially dodgy loans that might prove costly to the federal budget and taxpayers. (For example, if the FHA is willing to offer a $150,000 guarantee for a problem loan, the mortgage lender would not want to offload the loan if the loan's expected, risk-adjusted value is $170,000. But the lender would be happy to accept the guarantee if the loan's expected, risk-adjusted value is only $130,000.) Another issue is that most homeowners, who were more prudent in their borrowing, and renters who have refrained from buying homes because they knew they couldn't afford them would in many cases regard the guarantees as an unjust government reward to those who were less financially responsible.

To try to prevent borrowers from taking the bill as a signal to default intentionally in order to qualify for the mortgage-debt writedown, borrowers would have to be deeply indebted as of March 31, 2008. However, if borrowers already meet that test (or could understate their incomes in order to do so), the bill might motivate them to run up more debt or skip some mortgage payments in order to pressure their lenders into accepting the writedown in return for a government guarantee. Instead of helping the housing sector, this would hurt. Moreover, the loan guarantees would send the message to some households that they should be less financially disciplined going forward because a debt-financed consumption binge may qualify them for a future government bailout. This is known as the problem of moral hazard. Another concern is that although the FHA would supposedly only guarantee mortgages when there is a realistic chance of repayment, lenders and borrowers would have an incentive to game that requirement by making overly

optimistic assumptions about borrowers' ability to repay in order to shift risk to the government.

The Federal Reserve and the housing market

The Federal Reserve has pumped enormous quantities of liquidity into the financial system since the bubble popped. The Fed has not been trying specifically to assist the housing market; its efforts have been directed at keeping credit markets unblocked. Nevertheless, its actions have probably helped overextended homeowners and builders more than would any of the bills now in Congress. If not for the Fed's intervention, mortgage interest rates would be much higher than they are now, putting greater pressure on homeowners and builders. Instead, the rates on many types of mortgages are lower or only slightly higher than they were a year ago. And while loans have become harder to obtain, especially for those with uncertain credit, the total quantity of real estate loans at commercial banks has actually increased compared to a year ago, as have the quantities of consumer loans and commercial and industrial loans.

This is not to say the Fed should be commended for its overall performance. The Fed contributed to the housing bubble by keeping interest rates too low for too long earlier this decade. As former Fed chairman William McChesney Martin once said, one of the key jobs of a central bank is to take away the punch bowl just when the party really gets going. The Greenspan Fed left the punch bowl out too long. If not for the Fed's easy money, the bubble never would have become so large and caused so many bad investment decisions. Moreover, in responding to the bubble's collapse and financial market distress by pushing down short-term interest rates and pushing up the money supply, the Fed's current intervention has caused the value of the U.S. dollar to plunge in foreign exchange markets, raised food and oil prices, and, more generally, contributed to a bubble in commodity prices. Further, while the Fed's actions have reduced the pain for many heavily indebted homeowners and mortgage lenders, it has transferred the pain to others in society, such as seniors counting on bank CDs and similar investments for a comfortable retirement, who have seen their incomes plummet.

The Fed could have fulfilled its lender-of-last-resort role without generating as much inflation if it had better targeted its intervention. Many banks and investment houses had difficulty continuing normal credit operations because they were stuck holding large amounts of suddenly illiquid securities. If the Fed had promptly initiated temporary exchanges of those illiquid securities for Treasuries and other liquid assets, instead of waiting until the time of the Bear Stearns collapse to make that offer, it could have unclogged the financial system without flooding the system with easy credit. (Doing so would have more closely followed the advice that Walter Bagehot gave over a century ago in his classic work on central banking, *Lombard Street*.)

Better alternatives

To help resolve problem mortgages, Congress should examine whether any existing federal laws make it harder for lenders and borrowers to renegotiate mortgages if they want to do so voluntarily. Wherever possible, such laws should be removed or at least relaxed temporarily. To enhance housing affordability, which would benefit the public in the long run although it would not help with the current short-run adjustment, state and local governments should ask whether zoning laws, land-use laws, development taxes, or other government requirements raise construction costs, limit the availability of land for housing, or otherwise push down housing supply and drive up housing costs. Unless there are strong public policy reasons for keeping such laws on the books, they should be modified or removed. Similarly, local governments could make a positive contribution to housing prices by restraining their spending and cutting lower property taxes. Freeing the market from government-imposed restrictions so it could produce more housing would be pro-housing and pro-growth.

Similarly, local governments could make a positive contribution to housing prices by restraining their spending and cutting lower property taxes. Instead, some states and localities have retroactively changed the rules to make it harder for lenders to foreclose on homes. Such retroactive changes bring short-term relief to some troubled mortgagees, but they make it harder for would-be homeowners to obtain mortgages in the long term because lenders will respond by adding a political risk premium to mortgage rates in the future.

Also desirable would be pro-growth policies that do not specifically target housing but indirectly assist the housing market by expanding people's ability to afford housing. High on the list should be extending the elements of the 2001 and 2003 tax acts that lower marginal tax rates for work and saving, notably, the cut in the capital gains tax, the lowering of the tax rate on dividends, the reduction in the top tax rate brackets for individuals, and the elimination of the death tax. The United States now has one of the highest corporate tax rates in the world because other nations have been lowering their corporate tax rates while we have not. The rate differential discourages investment in this country relative to abroad. Therefore, another pro-growth reform would be to cut corporate income tax rates. Higher investment is one of the surest ways to create better paying jobs that allow people to buy more housing. Similarly, non-tax reforms, such as an overhaul of this country's tort system, should be examined, in order that government policies do not push so much investment and so many jobs abroad.

Conclusion

The housing bill that passed the Senate would use tax provisions and direct federal spending to prop up housing demand and to aid some homeowners who took on more debt than they could afford. On the House side, the Rangel and Frank bills have the same objectives. The centerpiece of the Frank bill is creating a new federal program to guarantee up to $300 billion of very shaky mortgage debt. In effect, the bills would try to blow some air back into the housing bubble.

These bills would increase the government's role in the housing market and its expenditures there. However, they would not be good for the housing market or the economy.

Some would argue that with housing prices down and mortgage defaults up, the government must experiment boldly. However, it should be remembered that past government interventions begun during financial crises, and subsequently enlarged, have a history of planting the seeds of future crises. For example, the government contributed to this country's last major financial crisis, the saving and loan debacle of the late 1980s and early 1990s, by encouraging the development of poorly diversified financial institutions that specialized in housing loans and by then increasing federal deposit insurance from $40,000 to $100,000. It contributed to the current crisis by creating government sponsored enterprises that specialized in the securitization of mortgages, which popularized the concept and made it seem safer than it proved to be, by demanding of lenders that mortgages be made available to more of the population, and by pressuring the Fed to ease monetary policy to promote growth when the correct policy mix is for the Fed to concentrate on promoting a sound dollar and the Congress to promote growth by reining in excessive government spending and lowering marginal tax rates. Those experiences argue for greater caution this time around.

Michael Schuyler
Senior Economist

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.