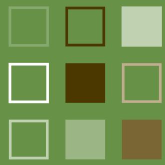

Economic Commentary

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Homeowner Subsidies

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Though some programs that were created to promote homeownership in the United States, like Fannie Mae and Freddie Mac, have been harshly criticized in the wake of the housing crisis, we are likely to continue to provide some form of taxpayer-funded assistance to those who would become homeowners. Historically, assistance has taken the form of either interest rate or down-payment subsidies, but recent research suggests that down-payment subsidies are much more effective. They create successful homeowners—homeowners who keep their homes—at a lower cost.

The notion that homeownership contributes to social harmony and to individuals' happiness and welfare is deeply rooted in the American psyche. Consequently, encouraging, subsidizing, and protecting homeownership are deeply ingrained in public policy. Under the assumption that as a nation, we will continue to encourage homeownership at some level, this *Commentary* examines housing subsidies and their impact on sustainable homeownership, especially for low- and moderate-income households.

While program names and terms vary, there are essentially two types of subsidies provided to housing markets: interest rate subsidies and down-payment assistance. Interest rate subsidies include the deductibility of mortgage interest for taxpayers who itemize deductions on their federal tax returns, and the federal tax exemption of interest income on municipal bonds that subsidize mortgages to low-income individuals. These subsidies are substantial. According to the fiscal year 2010 budget, the U.S. government will spend $780 billion in tax expenditures over the next five years to subsidize housing through mortgage interest and property tax deduction, a small fraction of which will go to low- and moderate-income households. Tax exclusion of interest on state mortgage revenue bonds will total some $5.8 billion over the next five years.

On the down-payment-assistance side, the Assets for Independence (AFI) Act provides matching funds to low-income savers who wish to buy a house. In 2008, $10.6 million saved by 7,542 AFI program participants was matched by $10.9 million in federal grants and $12.1 million in nonfederal funds. A more complete list of housing-related subsidies would show that interest rate subsidies are clearly the primary tool for encouraging homeownership.

I do not intend to criticize or justify the policy decision to promote homeownership. However, given the vast resources we devote to this policy and the ordeal the housing market is going through now, it is useful to take a step back and evaluate the way the policy promotes homeownership. The policy has essentially two goals: making homeownership accessible (affordable) and making it sustainable (by creating homeowners who maintain their properties and do not default). Interest subsidies may be successful at increasing the affordability of owner-occupied housing and improving the sustainability by lowering monthly payments, but recent research suggests that down-payment assistance is the superior way to achieve both goals.

Why Do Down Payments Matter?

The developments in our mortgage markets in the last decade or so are an excellent case study for why down payments matter, or what happens when they are overlooked. Not too long ago, homebuyers had to put 20 percent down on a house, show proof of income, and demonstrate creditworthiness before a lender would consider them for a mortgage. But these standards seemed too conservative and restrictive to lenders in the late 1990s, when unemployment was hovering around all-time lows, and the housing market seemed to be in a permanent bull market.

Research shows that lending standards became more lax over this period. Among other things, down payments were no longer a necessity. At the peak of the market, for example, so-called piggy-back mortgage deals allowed homebuyers to borrow 10 percent or 20 percent of a home's value and use those borrowed monies to meet the down-payment requirements of their mortgages. The positive consequence of this easier access to credit was that the rate of homeownership increased from 65 percent in 1996 to more than 69 percent in 2006—a record high. But on the negative side, the homeownership gains turned out to be mostly unsustainable. Many of the low- and moderate-income homeowners subsequently lost their homes during the financial crisis, and many neighborhoods fell further into disrepair.

In hindsight, lenders may have underestimated the benefits of a sizeable down payment during the housing boom of the last decade. Before the housing-price bust in 2006, lenders increasingly seemed to rely on rising home prices as protection from loss in their underwriting decisions. After all, steadily rising home prices reduced the likelihood that homeowners would default on their mortgages by creating sufficient equity in the home. That equity allowed financially distressed homeowners to sell their properties instead of defaulting on their mortgages. And in cases where the homeowner did default, the increased value of the home reduced the loss to the lender from foreclosing on the property. But it has now become clear that relying on price appreciation alone to build equity and enable distressed homeowners to exit gracefully from their mortgages is not a wise strategy; it is a recipe for a foreclosure crisis.

Would events have been any different if homebuyers had come to the closing table with bigger down payments, though mortgage terms and housing market conditions had remained the same? Perhaps. Homeowners who supply down payments start out with substantial equity positions in their homes, and having that equity is associated with a number of beneficial outcomes. First, a substantial equity position reduces the chances of default. So even if adverse changes to some homeowners' finances (such as job loss or high healthcare costs) had forced them to exit homeownership during the time housing prices were falling so sharply, their equity would have given them options that made default less appealing.

For example, homeowners who have equity in their homes may be able to move more easily from one region to another or from owner-occupied to rental housing than those without sufficient equity. This is because even in the best of times, homes are illiquid assets; they are difficult to sell quickly without accepting a price below their market value. Research has indeed shown that homeowners who have negative equity in their homes are one-third less likely to move.

In general, the benefit of higher homeowner equity is that it makes sellers more flexible in pricing, and reduces the time a house stays on the market. For a homeowner who lacks any pricing flexibility because the mortgage exceeds the value of his home, the only way out of homeownership is to pay the difference to the lender or to let the lender take over the property with all the associated damage to the homeowner's credit history.

Down payments also solve some problems for lenders. Since homes are the collateral protecting lenders against losses for the mortgages they extend, they want to ensure properties are maintained so that they keep their value. Homeowners with equity in their property are more likely to maintain the property than those without equity. In addition, a down payment allows a lender to charge a lower interest rate on the loan. This in turn frees up income that a homeowner can use to maintain the house—which is collectively in the interest of the lender and homeowner. These are the skin-in-the-game effects of down payments.

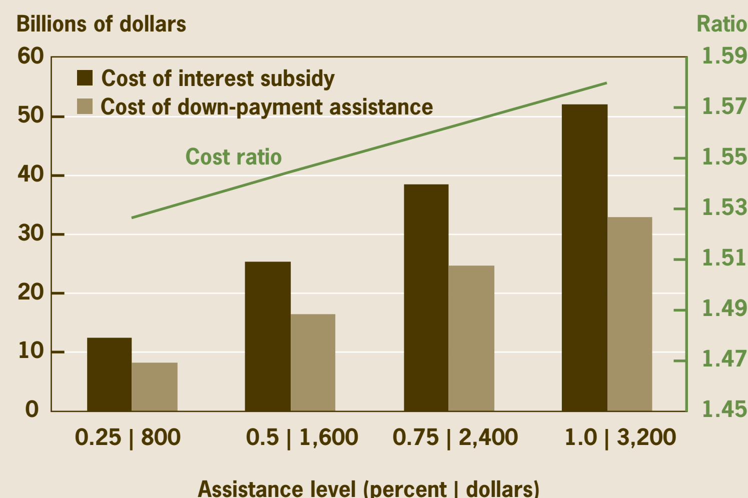
Simply subsidizing the mortgage rate does not provide the same benefits as a down payment. A lower rate would surely make payments more affordable and lower the instance of defaults. However, it would not ensure a substantial equity position or its primary benefits. It provides no graceful exit door to homeowners during bad times, because having a great deal on the mortgage will not help the homeowner sell the house. Neither would a lower rate give homeowners an incentive to maintain their property, just as great rental car deals don't give drivers an incentive to wash the car.

The overwhelming majority of government programs targeting individuals in the housing market are intended to encourage borrowing by lowering interest costs. Reviewing the benefits of down payments, though, suggests that focusing on larger down payments may be more advantageous. There's one other important argument for shifting our attention to down-payment assistance. It looks to be a whole lot cheaper.

Sustainability, but at What Price?

Given that homeowner subsidies are likely to persist, we need to find the most effective way to deliver them. In a recent study of low- and moderate-income households, I compared the impact of mortgage rates and down payments on mortgage defaults and estimated the cost of two hypothetical government programs: one that subsidizes mortgage rates and one that provides down-payment assistance. The goal of these hypothetical programs was not just to make low- and moderate-income people homeowners but to make sure that they could sustain their homeownership. Therefore, to measure the programs' effectiveness, I focused on

Figure 1. The Cost of Assistance Programs



Note: The cost ratio is the ratio of the cost of the interest rate subsidy to the cost of the down-payment assistance.
Source: Ergungor, 2010.

how they affected mortgage defaults, and I estimated the cost of reducing the likelihood of mortgage defaults by the same amount in each program.

I found that to achieve the same reduction in default risk from a 1 basis point decline in mortgage rates, low- and moderate-income homebuyers would need a supplemental down payment of $32. For example, a 25 basis point mortgage rate subsidy is equivalent to an $800 supplemental down payment in that they both reduce default rates by 19 basis points. Each additional 25 basis points reduces the default rate by about an additional 19 basis points. I also found that the total resources needed to provide all such borrowers with the extra down payment are about two-thirds of the cost of an interest-subsidy program over a 15-year period. It is important to note, however, that the quality of the data used in the analysis is less than ideal, and better data may affect these results. Still, as a first effort, the study shows that focusing on increasing down payments may be more advantageous to the taxpayer.

With this caveat in mind, figure 1 shows the resources needed to subsidize interest rates or down payments at various levels of the subsidy. The ratio displayed is the ratio of the cost of the interest rate subsidy to the cost of the down-payment assistance. The upward slope indicates that the interest rate subsidy becomes more expensive at higher levels of the subsidy. The reason is the payment-contingent nature of the interest rate subsidy. That is, the homeowner benefits from this subsidy as long as he continues to make his payments. If the homebuyer defaults, he can no longer take advantage of a below-market mortgage rate. A larger subsidy increases the cost of the program not just because homebuyers receive a larger subsidy but also because more of them survive to continue to receive it. This survivorship effect is not present in the down-payment program because every qualified homebuyer receives the assistance, including those who will default in the future.

A lower cost is not the only advantage of a down-payment program. Researchers have shown that the greatest barrier to low- and moderate-income homeownership is the lack of a down payment. More people decide to become homeowners when the down-payment restrictions are eased than when mortgage rates are reduced. My calculations using the findings of previous researchers suggest that a 1 percent interest rate subsidy may create an additional 74,000 homebuyers, but down-payment assistance of $3,200 could attract 541,000 new homebuyers. Even after accounting for the cost of the additional new homebuyers, the down-payment program is still cheaper.

As I noted above, these types of calculations come with a significant margin of error. So the $3,200 figure is for the purpose of discussion only, and it is not intended as a recommendation. The message of my study is that we may get more sustainability bang for each subsidy buck if the buck is spent in the form of down-payment assistance.

To make this simple point, my study assumes that the additional down payment comes from the government. But a higher down payment does not have to be in "assistance" form in its entirety. In fact, one potential policy goal in the future could be to facilitate a return to the old strategy of saving to become a homeowner.

Developing the Savings Tools

Building savings in low- and moderate-income communities is tricky. While low income levels are an obvious factor, researchers have also identified deeply ingrained pessimistic attitudes toward saving. Children who grow up in families without a habit of saving do not save themselves and do not believe that they would be successful at saving. But when they go through financial education programs to learn basic money skills, many of them do succeed at building their savings. There may also be cultural factors. For example, surveys of low-income households identify one source of pessimism as the pressure savers feel from members of their support network (friends and family) to share their savings.

One tool that seems to work at overcoming some of these obstacles is the Individual Development Account (IDA). IDAs are savings accounts established with local financial institutions and managed by community organizations in the name of a low- or moderate-income individual for the purpose of encouraging saving toward starting a business, paying for education or job training, or buying a home. IDA programs typically provide $1 to $3 in matching funds for every dollar saved by the individual participant. The matching funds come from public and private sources; the federal Assets for Independence program mentioned earlier requires IDA sponsors to raise private funds to match the federal money supplied. The match comes with some strings attached. For example, participants must save for a minimum length of time before they can withdraw their savings without losing the matching funds. They must also get training in financial literacy before they can use the money.

There are some studies which suggest that IDAs encourage new savings, but we still do not have strong empirical evidence that the saving rate does indeed increase. For example, a Department of Health and Human Services report to Congress on the AFI program shows that 7,542 participants in IDA programs saved $1,418 on average toward a home purchase, but it is not clear how much of those savings came from the cannibalization of other savings accounts; that is, savers may have merely transferred cash they had already saved in other accounts to the IDA or they may have put money in the IDA that they would have saved anyway.

This is just one example of the issues that we need to understand better before we settle on a particular tool to encourage saving for homeownership. Many new ideas are likely to burgeon out of the ongoing policy debate.

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Low- and Moderate-Income Homeowners: The Next Generation

Our housing policy will inevitably be shaped by the experiences of the last financial crisis. High homeownership rates among low- and moderate-income households that are achieved at the expense of lower underwriting standards are clearly not sustainable. Therefore, it is very likely that homeownership will no longer be open to every household going forward. Homeowners at the lowest level of the income distribution who do not have the means to save for a down payment and other inevitable costs of homeownership may find that rental housing is their only option.

However, there are other approaches to promoting homeownership to consider and investigate, such as tools that can help individuals augment their saving capabilities. Whether policymakers will choose to use IDAs to encourage saving toward homeownership or create a completely new tool remains to be seen. One would hope that the next generation of low- and moderate-income homebuyers will be better prepared for homeownership than any generation in the past.

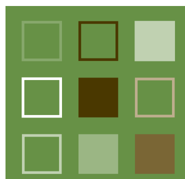
Recommended Reading

"Homeownership for the Long Run: An Analysis of Homeowner Subsidies," O. Emre Ergungor, 2010. Federal Reserve Bank of Cleveland, working paper no. 10-21R.

"Housing Busts and Household Mobility," Fernando Ferreira, Joseph Gyourko, and Joseph Tracy, 2010. *Journal of Urban Economics*, vol. 68, pp. 34–45.

"Equity and Time to Sale in the Real Estate Market," David Genesove and Christopher Mayer, 1997. *American Economic Review,* vol. 87, pp. 255–69.

Can the Poor Save? Saving and Asset Building in Individual Development Accounts, Mark Schreiner and Michael Sherraden, 2007. Transaction Publishers: New Brunswick, NJ.



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