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White Picket Fence? Not So Fast

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THE United States spends more than $100 billion annually to subsidize homeowners. Renters get no breaks; homeowners get tons of them. Their mortgage rates are subsidized through the government-sponsored enterprises Fannie Mae and Freddie Mac; they get a big deduction on federal income taxes for mortgage interest payments and for state and local property taxes; and they even get favored treatment on capital gains from the sales of primary residences.

Americans love the idea of a house and a white picket fence. The government encourages ownership through housing subsidies, believing that it stabilizes communities. Owners see their homes as their share of the American dream, and their best way to save money.

But according to the Congressional Joint Committee on Taxation, these tax breaks add up to $700 billion in lost government revenue over the five-year period through 2014. As the government struggles to come up with spending cuts and revenue sources, housing subsidies are an obvious place to look.

Until recently, support for home ownership was untouchable because the programs were popular with voters and because of unrelenting lobbying efforts. The political right sold them as part of its "ownership society," whereas the left used them to fight rising income inequality. But the policies have turned into a major disappointment for both sides.

According to data collected by Alex J. Pollock of the American Enterprise Institute, a comparison of homeownership among economically advanced countries shows that the United States is in the middle of the pack, which suggests that subsidizing housing with tax breaks is neither a necessary nor a sufficient condition for a flourishing housing market. Rather, these subsidies enabled people to borrow more than they could afford so they could buy houses bigger than they needed, leading to a house price bubble. The policies encouraged homeowners to make highly leveraged bets on real estate that turned sour and wiped out nearly $8 trillion in household net worth.

Moreover, homeownership policies and mortgage subsidies in the United States benefit the rich a lot more than the poor. For example, the economists James Poterba and Todd Sinai recently estimated that the benefits from the mortgage interest deduction for the average homeowning household that earns between $40,000 and $75,000 were about 10 times smaller than the benefits that accrue to the average household earning more than $250,000. These policies increase income inequality instead of reducing it.

A better policy would be to gradually wind down Freddie Mac and Fannie Mae and to scale back homeownership subsidies. We favor a long-term focus on rental assistance programs for the poor that are on budget and housed in the Federal Housing Administration, and whose costs are transparent to taxpayers.

That said, weaning housing finance off the government cannot happen overnight. We liken this to the way one would treat a patient with a drug addiction. One would not double the dose (which is arguably what we have been doing), but neither would one go cold turkey. Existing subsidies would be honored. And to minimize the system-wide shock of closing Fannie and Freddie and removing government support, we envision a decade-long transition from where we are today to where we need to be.

This new housing policy will lead to a different economy. As subsidies to the housing sector are removed, American households will take on less debt and there will be less overconsumption of housing. The private sector will shift its investments from the housing sector to areas of the economy that offer higher rates of return, like human capital, infrastructure projects and capital business projects in other industries. The long-term impact will be tectonic in nature, leading to higher economic growth and a more stable financial system.

Why is this relevant now? The budgetary problems of the United States are dire. Economic growth is anemic. Reforming the American housing finance system will improve the budget and stimulate growth and will make a real contribution to our future prosperity.

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