CONGRESSIONAL TESTIMONY

Closing the Gap in Wealth Creation with Economic Opportunity

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My name is Joel Griffith. I am a Research Fellow in Financial Regulations at The Heritage Foundation. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

Efforts to expand home ownership through government programs or policies are often well-intentioned. However, good intentions are an insufficient basis for public policy. Directing resources to the housing sector through government subsidies, guarantees, and mandates may temporarily increase home ownership rates, dramatically increase home prices, and financially benefit select special interests. However, this negatively impacts affordability for all—including minorities—and distorts economic growth.

Furthermore, a focus on simply expanding home ownership fails to recognize that home ownership may be indicative of the financial health of a family; but extending a borrower credit through use of a government guarantee does not suddenly improve a borrower's financial health, enhance his skillset, or expand his economic opportunities. In other words, home ownership results from financial health, a profitable skillset, and economic opportunity.These desirable conditions are not created by virtue of owning a home.

Closing the gap in wealth accumulation—and multiplying the opportunities to create such wealth—requires an approach different from government subsidies, guarantees, and mandates. Congress can—and should—make housing more affordable, and diminish risk, by *shrinking* the federal role in housing finance. State and local governments should eliminate artificial barriers to affordability and economic growth. To better equip the next generation to prosper, parents should be enabled to select alternatives to underperforming public schools.

Home ownership can help families build household wealth over time. For many, a personal residence represents the primary or even the majority of a family's financial assets. Nationally, owner's equity in real estate reached a record $15.2 trillion in 2018.[1]

However, data show the heavy government involvement in the home finance sector failed to substantially increase homeownership; instead, it yielded a short-term and unsustainable increase in home ownership rates. Robust homeownership was established in the U.S. long before the government became heavily involved in the housing market. From 1949 to 1968 (the year that Fannie Mae was allowed to purchase non-government-insured mortgages), government-backed mortgages never accounted for more than 6 percent of the market in any given year.[2] Yet the homeownership rate was 64 percent in 1968, virtually identical to what it is now after decades of heavy government involvement in housing finance.

Home ownership for blacks grew from 35 percent in 1950, to 42 percent in 1970, and to 44 percent in 1980. By 1990, black home ownership had actually declined slightly to 43 percent despite a decade of secondary mortgage market expansion.[3] In 2019, the black home ownership rate is back to 1970 levels—at 41 percent.[4]

Just how large was the expansion of government influence in the housing finance market? From 1990 to 2003, Fannie and Freddie went from holding 5 percent of the nation's mortgages ($136 billion) to more than 20 percent ($1.6 trillion).[5] Investors who purchased Fannie and Freddie's bonds and mortgage-backed securities (MBSs) ultimately provided funds for people to finance homes, and these bondholders and MBS investors enjoyed implicit government backing. It was common knowledge that taxpayers would make good on promised cash flows if either Fannie or Freddie were to ever fail financially. This feature led to riskier lending than would have taken place without such guarantees because it allowed investors to ignore the true financial risks of those underlying mortgages and securities.[6]

GSEs dominated the mortgage market in the years leading into the crisis. Trillions of dollars of credit flowed to those with lower credit scores, minimal income documentation, less-stable employment history, and scant down payments.[7] This helped produce a doubling in overall home prices from 1998 to 2006. The collapse and financial misery which followed hurt many of the intended beneficiaries of these government mandates, subsidies, and guarantees. The fact that homeownership rates for blacks (and for the nation as a whole) are nearly unchanged now compared with 1990 indicates additional leverage should not be relied upon to increase the rate of ownership. Rather than recognize this reality, congressional inaction has expanded the government's role in the wake of the prior financial

[1] Board of Governors of the Federal Reserve System (US), Households; Owners' Equity in Real Estate, Level [OEHRENWBSHNO], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/OEHRENWBSHNO, May 6, 2019.

[2] Norbert J. Michel and John Ligon, "GSE Reform: The Economic Effects of Eliminating a Government Guarantee in Housing Finance," Heritage Foundation Backgrounder No. 2877, February 7, 2014, p. 6, https://www.heritage.org/housing/report/gse-reform-the-economic-effects-eliminating-government-guarantee-housing-finance.

[3] U.S. Census Bureau, Historical Census of Housing Tables Ownership Rates, https://www.census.gov/hhes/www/housing/census/historic/ownrate.html.

[4] U.S. Census Bureau, Homeownership Rate for the United States: Black or African American Alone [BOAAAHORUSQ156N], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BOAAAHORUSQ156N, May 6, 2019.

[5] Ibid.

[6] The Congressional Budget Office (CBO) advises that "the unpriced implicit guarantee, which reduced interest rates for mortgage borrowers, helped cause more of the economy's capital to be invested in housing than might otherwise have been the case." Congressional Budget Office, Transitioning to Alternative Structures for Housing Finance: An Update, August 2018, p. 7, https://www.cbo.gov/system/files?file=2018-08/54218-GSEupdate.pdf.

[7] "[B]y the middle of 2007, there were approximately 27 million subprime and Alt-A mortgages in the U.S. financial system—half of all mortgages outstanding—with an aggregate value of over $4.5 trillion." Peter J. Wallison, "Dissent from the Majority Report of the Financial Crises Inquiry Commission," American Enterprise Institute, January 14, 2011, p. 9, http://www.aei.org/wp-content/uploads/2011/01/Wallisondissent.pdf.

crisis, leading once again to higher home prices and increased taxpayer risk.

The continued government guarantees and subsidies in the wake of the housing market collapse have dangerously propped up housing prices as capital flowed back into the housing market. After bottoming out 27 percent below the peak, home prices have spiked 54 percent since 2012, more than quadruple the rate of inflation.[8] Adjusted for inflation, residential property prices in the United States by the middle of 2018 had reached the levels of 2004—as the prior bubble neared its 2006 climax.[9]

The home-price-to-income ratio now stands at more than 3.5 (nearing the 4.0 peak in 2006), significantly higher than the historic norm of around 2.8.[10] The decline in 30-year fixed interest rates from an average of 6.6 percent at the prior peak to a low of just 3.88 percent as the recovery began masked the impact of the rising home costs on affordability. Indeed, with mortgage rates now exceeding 4.6 percent, affordability concerns are beginning to surface again. Mortgage payments on median-priced homes as a percentage of income bottomed out at just 12.4 percent in late 2012 as interest rates dropped and home prices sank. This mortgage-payment-to-income ratio is now nearing 18 percent—the highest level since 2008.[11] A return to 6.6 percent 30-year fixed mortgage rates (still below the historical average) would increase a mortgage payment by 25 percent even with no increase in home prices.

Inducing a continued misallocation of capital to the housing sector through subsidies and government guarantees of MBSs will perpetuate inflated prices, deprive other sectors of needed financial resources, and place the burden of catastrophic risk on the federal taxpayer. It is difficult to argue that these policies improve the status quo for anyone other than the lenders, securitizers, and MBS investors who will gain additional federal protections.

Federal Housing Reforms: Several basic federal housing reforms would substantially diminish the negative consequences of the current system.[12] Based on The Taxpayer Protection Housing Finance Plan, a proposal authored by American Enterprise scholar Ed Pinto and other contributors, these policy changes include the following:

- Eliminate the geographic price differentials for conforming loan limits.
- Narrow the GSEs' focus to the financing of primary homes. This change involves eliminating support for second homes, vacation homes, investment properties, and cash-out refinancing. In particular, subsidizing cash-out refinances impedes the likelihood of middle class families accumulating net worth.
- Begin a broader reduction in conforming loan limits over five to 10 years.

As it stands now, approximately 90 percent of GSE volume is devoted to refinances, investor purchases, lower loan-to-value (LTV) loans, and pricier homes purchased by higher income earners.[13] In other words, the current system—itself an

[8] S&P Dow Jones Indices LLC, S&P/Case-Shiller U.S. National Home Price Index [CSUSHPINSA], retrieved from FRED, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/CSUSHPINSA. The Case-Shiller Home Price Index is an index that tracks home prices given a constant level of quality. See S&P Dow Jones Indices, "Real Estate: S&P CoreLogic Case-Shiller Home Price Indices," https://us.spindices.com/index-family/real-estate/sp-corelogic-case-shiller.

[9] Board of Governors of the Federal Reserve System, Federal Reserve Bank of St. Louis, Series QUSR628BIS, https://fred.stlouisfed.org.

[10] Zillow Research, "Data: Definitions–Other Metrics," second-to-last bullet point: "Mortgage Affordability, Rental Affordability, Price-to-Income Ratio, and Household Income are calculated as a part of Zillow's quarterly Affordability Indices." https://www.zillow.com/research/data/(accessed December 13, 2018).

[11] Ibid.

[12] Peter J. Wallison and Edward J. Pinto, eds., "The Taxpayer Protection Housing Finance Plan: Gradually Winding Down Fannie Mae and Freddie Mac and Improving the FHA," American Enterprise Institute, January 2018, p. 21, https://www.aei.org/wp-content/uploads/2018/02/Taxpayer-and-Home-Buyer-Protection-Housing-Finance-Plan-1.26.18.pdf.

[13] Peter J. Wallison and Edward J. Pinto, eds., "The Taxpayer Protection Housing Finance Plan: Gradually Winding Down

extension of the failed GSE framework—does little to broadly support homeownership.

Enacting these reforms will enhance housing affordability (particularly for first-time home buyers), diminish systemic and taxpayer risk, and result in less personal debt and more personal savings.

Zoning and Regulations. State and local governments should eliminate artificial barriers to affordability and economic growth. Federal housing reform cannot fully mitigate the suppression of opportunity by these misguided local policies. Regulations are costly to businesses and individuals, they lower real incomes, reduce entrepreneurship, exacerbate income inequality, and increase the price of consumer goods. Requirements for unionized labor, minimum wages, occupational licensing, and zoning restrictions are just a few examples. A strong measurable relationship exists between increases in regulatory restrictions and increases in poverty. [14] Regulatory costs are regressive, harming lower-income Americans the most forcing businesses that cannot compete to prematurely automate operations or become more selective in hiring.[15]

The unintended consequences of high regulatory burdens are often hard to see as they fall on those least equipped to navigate the bureaucracy. Reducing and streamlining labor, zoning, and business restrictions could go a long way toward increasing opportunity and prosperity in the minority communities disproportionately affected by these burdens.

Education Choice. Failing schools contribute to a relative lack of education, marketable skills, and other forms of human capital, which directly impacts earnings capacity. To better equip the next generation to prosper, parents should be enabled to select educational alternatives for their children. Many of the underperforming public schools are located in economically deprived areas with a disproportionately large minority population.[16]

Elevated numbers of students drop out before graduation; many graduates lack proficiency in basic reading, writing, math and specialized skills.[17] The government granted education monopoly fails millions of students who are subsequently unable to effectively compete in the labor market. Education choice options that allow students and parents to choose the best school for them, have been shown to help the poorest students attain better outcomes over government assigned schools.[18]

Over time, the opportunity gap between minorities and the rest of the nation will close due to enhanced educational quality. This will translate into greater income and wealth accumulation.

Conclusion: Optimally, Congress will work to make housing more affordable by gradually removing federal guarantees and subsidies and eliminating federal mandates. The economy will further benefit as

Fannie Mae and Freddie Mac and Improving the FHA," American Enterprise Institute, January 2018, pp. 12 and 13, https://www.aei.org/wp-content/uploads/2018/02/Taxpayer-and-Home-Buyer-Protection-Housing-Finance-Plan-1.26.18.pdf (accessed December 13, 2018).

[14] Dustin Chambers, Patrick A. McLaughlin, and Laura Stanley, "Regulation and Poverty: An Empirical Examination of the Relationship between the Incidence of Federal Regulation and the Occurrence of Poverty across the States," Mercatus *Working Paper*, April 2018, https://www.mercatus.org/system/files/chambers-regulation-poverty-mercatus-working-paper-v1.pdf.

[15] Janna E. Johnson and Morris M. Kleiner, "Is Occupational Licensing a Barrier to Interstate Migration?," National Bureau of Economic Research *Working Paper* No. 24107, December 2017, https://www.nber.org/papers/w24107.

[16] Duncombe, Chris. "Unequal Opportunities: Fewer Resources, Worse Outcomes for Students in Schools with Concentrated Poverty," Commonwealth Institute, October 26, 2017, https://www.thecommonwealthinstitute.org/2017/10/26/unequal-opportunities-fewer-resources-worse-outcomes-for-students-in-schools-with-concentrated-poverty/.

[17] *The Condition of Education 2018*, National Center for Education Statistics, U.S. Department of Education, 2018, p. 4, https://nces.ed.gov/programs/coe/pdf/coe_cnb.pdf.

[18] Jason Bedrick and Lindsey M. Burke, "The Next Step in School Choice," National Affairs, Winter 2015, https://www.nationalaffairs.com/publications/detail/the-next-step-in-school-choice.

the artificially large flow of capital to the housing market is allocated to other sectors. State and local governments share a responsibility to eliminate artificial barriers to housing affordability and economic growth. In order to expand the capacity to accumulate wealth and have access to economic opportunity, states should pursue policies expanding educational choice. Far too many children are trapped in schools inadequately equipping them to succeed. These steps to diminish government interference in housing finance and to unlock human potential will expand economic opportunities for all.

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