INDUSTRY PERSPECTIVES

The Homeownership Rate and Housing Finance Policy

Part 2: Heavy Lift to Break the 65 Percent Barrier

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The Homeownership Rate and Housing Finance Policy – Part 2: The Heavy Lift to Break the 65 Percent Barrier

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Introduction

The homeownership rate – currently around 65 percent, a level first reached half a century ago – is broadly regarded by policymakers as a core measure of how well the US socioeconomic system is delivering a good quality of life for the typical American family. As described in "The Homeownership Rate and Housing Finance Policy – Part 1: Learning from the Rate's History," the benefits of homeownership are substantial. First, it is the primary mechanism for the typical family to build wealth for retirement or to help the next generation. Second, it brings social stability, as the homeowning family no longer is subject to landlord actions that might force relocation or unreasonably raise rents.

Consequently, public policy in housing has long had an objective to sustainably increase the homeownership rate. Unfortunately, efforts in the last five decades to do just that have simply failed as the rate is the same today as it was back in the late 1960s, i.e. about 65 percent. (Even worse, the much-applauded increase beginning in the early 2000s proved entirely unsustainable, with terrible damage to families and the economy when the mortgage bubble burst in 2007-8.) As a result, millions more families who could have enjoyed the benefits of an increased homeownership rate have missed out. The purpose of this article is to lay out several key policies that, if well-implemented, could finally accomplish just such an increase, a challenge unfortunately made much harder by pandemic distortions that have dramatically raised the price of homes nationwide.

The history, also described in Part 1 and which goes back 130 years (i.e., closer to the founding of the country than to today), makes clear that a permanent and sustainable increase of more than a few percentage points in the homeownership rate is a very, very hard thing to accomplish.

- For the first forty years, starting in 1890, the rate stayed at 46.5 percent, plus or minus only 1.5 percentage points, despite major changes in the economy and demographics of the country during that time period.
- Beginning in 1930, under the extraordinary twin dislocations of the Great Depression and then World War II, the rate increased almost 20 percentage points by the end of the post-war era. This extraordinary increase reflected many major changes in American life and specifically in housing finance. First, amidst all the economic programs enacted during the 1930s, there were various government interventions into housing finance that resulted, post-war, in a rather different mortgage system: one that was very low-cost and borrower-friendly, but also heavily based upon government support and subsidies. Second, the homeownership rate post-World War II also benefitted greatly from several key non-mortgage developments: (1) the unprecedented investment in

human capital via wartime military service and then the GI Bill; (2) the invention, beginning in the late 1940s, of the modern, low-cost commuter suburbs, based partly upon taxpayer-funded infrastructure; and (3) a long-term post-war economic boom that reflected in particular America's status as the only major developed country with its industrial assets not devastated by the war.

- By the end of the 1960s, reflecting all the Great Depression and World War II-related changes, the homeownership rate leveled out at about 65 percent. There it has remained, plus or minus 2 percentage points ever since[1] – i.e., for more than a half-century.

Interestingly, while the role of government in housing and the broader economy was quite modest from 1890 to 1930, when the homeownership rate was stable, that role has been quite large and active during the fifty years since the late 1960s, in part with the goal of further increasing the homeownership rate beyond 65 percent. As described in Part 1, the government's efforts were centered in unfunded mandates from Congress (e.g., the Community Reinvestment Act and the Affordable Housing Goals for the two government-sponsored enterprises (GSEs) Freddie Mac and Fannie Mae), as well as in hidden cross-subsidies for mortgage interest rates by all four government mortgage agencies.[2] However, the impact of those efforts came to little, as the homeownership rate remains unchanged in that 65 percent range.

The only realistic conclusion that can be made is that the homeownership rate is extraordinarily sticky, and that limited or technical initiatives or other narrow measures will not succeed in materially raising it. Instead, it is necessary to think big and broad and put real dollars behind the effort; in particular, a successful policy will have to effectively target families who are positioned to move from rental to ownership, rather than just supporting homeownership broadly. As described below, such targeting has not historically been a priority for the biggest subsidies to homeownership.

The housing-related fallout from the COVID-19 pandemic has unfortunately made raising the homeownership rate even more difficult. When the pandemic began to impact the economy in March 2020, there initially was fear that we might see some sort of replay of the 2008 financial crisis, in which house prices declined by about 25 percent.[3] To everyone's surprise, the pandemic has instead produced

[1] The only exception to this stability was the unsustainable run-up during the years of the mortgage bubble.
[2] The two GSEs, the Federal Housing Administration (FHA), and the Department of Veterans Affairs (VA).
[3] There are several prominent indexes of house prices, all telling roughly the same story. In this paper, I use one from the Federal Housing Finance Agency (FHFA), the regulator of the two GSEs plus the Federal Home Loan Banks. As it excludes transactions with very large mortgages, it is a better reflection of prices that are important for

a major financial windfall for existing homeowners: home prices are *up* by 26.1 percent in just twenty months (i.e., from February 2020 to October 2021, the latest data available) since the pandemic began.[4] They are also likely to keep rising for the next few quarters, although probably not as rapidly, producing a cumulative increase in just two years that will, amazingly, well surpass the decline during the financial crisis over a decade ago. Unfortunately, what has been so beneficial for existing homeowners has been a disaster for first-time homebuyers (FTHBs), who now face a devastating shock to their plans to save enough for the downpayment needed to purchase that first home. This unprecedented housing price increase should presumably press down hard on the homeownership rate, and so we might see it for the first time since the 1960s shift materially away from 65 percent – but, sadly and unexpectedly, in the form of a decline rather than an increase.[5]

In other words, the challenge of raising the homeownership rate – already hard enough given its 130-year history – just got even harder. Realistically, the first priority of the program described herein will be to help counter a likely price-driven decline in the rate over the next few years. In fact, if the rate does not go down in the next few years given the shock of such higher home prices, it will be a major policy success. A significant increase above 65 percent – for example, to 70 percent or more – would then emerge only in the longer term.

Facing the high historical stickiness of the homeownership rate, I describe in this paper three initiatives designed to increase it; each is about a well-targeted and sizeable subsidy, plain and simple. In my view, again, this approach differs from those that have historically dominated policy discussion, which has focused mostly on more technical or unfunded mandate approaches that have broadly not worked in the last fifty years. Fortunately, however, there are already existing very large and long-established subsidies to homeownership, and so two of the three initiatives are about strongly re-targeting these subsidies towards first-time homebuyers, rather than just broadly supporting homeownership: (1) the mortgage interest deduction for federal income tax payments, and (2) the interest rate cross-subsidies of the two GSEs. The third initiative is to create a new subsidy in the form of a well-constructed and highly targeted downpayment assistance program in line with that proposed by the recent Biden presidential campaign, which has inspired a breakthrough in the thinking behind the

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policymaking about the homeownership rate, which is centered upon more modest-income families graduating from renting to owning. See https://www.fhfa.gov/DataTools/Downloads/Pages/House-Price-Index.aspx, for monthly seasonally-adjusted data.

[4] From February 2020 to October 2021 (the latest available) on a seasonally-adjusted basis.

[5] For more on this topic and other impacts of this large increase in house prices, see my recent post: Don Layton, "What Do Runaway House Prices Mean for the US?," *Housing Perspectives*, Harvard Joint Center for Housing Studies, October 6, 2021, https://jchs.harvard.edu/blog/what-do-runaway-home-prices-mean-us.

design of such program, and which I believe has great potential. Together, these subsidies can significantly reduce the downpayment and monthly interest cost for a typical targeted beneficiary.

I then address in some detail the related and important topic of the shortfall in the number of homes being constructed as, without eliminating barriers to the building of considerably more homes per year than we have in the past decade, a new subsidy in the form of downpayment assistance legislation will simply not be effective in raising the homeownership rate; it would be likely instead to further raise the price of housing, which is already too high relative to incomes. My conclusion is that the elimination of that shortfall requires that a very high-profile, bipartisan, and long-term push is needed at the federal government level to address its multiple and longstanding causes.

I first lay the groundwork for these four topics – my three proposed initiatives and the construction shortfall – by reviewing several key issues that are important to the homeownership rate's going up rather than down, but in a somewhat cursory fashion as they are outside the core focus of this paper.

I have also constructed the policy recommendations in this paper with two key design criteria in mind:

1. They must be consistent with, not contrary to, the safety-and-soundness and stability of the financial system.
2. The resulting policies to increase the homeownership rate must be sustainable, which in this paper I specifically define to mean that such policies, if house prices were to stagnate or decline, must not lead to an undue increase in foreclosures or homeownership stresses that would tend to materially decrease the homeownership rate.

The collapse of the mortgage bubble in 2007-8 showed how much damage can be inflicted on families and the broader economy when these two design criteria are not adequately respected.[6]

Additionally, as a pragmatic matter, I have tried to work within existing government policies and programs and also business practices in the mortgage system so that implementation is easier and more likely to occur, rather than trying to conjure up programs out of whole cloth that are unlikely to ever actually see the light of day.

[6] In the financial crisis of that time, too much mortgage credit risk was held by inadequately capitalized lenders, and declining house prices triggered mass homeownership distress and foreclosures through, among other mechanisms, mortgage loans that had features like teaser rates, ultra-high loan-to-value ratios on top of lax lending standards, and so on.

While this paper is focused on the single, overall national homeownership rate, I conclude with a high-level discussion about the impact the recommendations would have on today's racial homeownership gaps. As will be shown, this impact is important to understand since, as the non-Hispanic white homeownership rate is already high, the potential for improving the national average rate is noticeably concentrated in improving the rate for people of color.

Background: Key Caveats and Related Topics

The homeownership rate does not stand alone, and policies to improve it are impacted by many other important factors. For the recommendations described herein to be well-constructed and effective, they must take account of those other factors.

Policy vs. Politics

Unsurprisingly, no policy emanating from the government is likely to remain uninfluenced by political considerations. Such influence can come from economic and ideological interest groups and their lobbyists, or through elected officials hoping to shore up their chances of re-election by helping particular constituencies. Government programs to extend credit or insurance are no exception to this rule: they have a long history of being distorted for political reasons. The most common distortions affecting them have been lax credit or underwriting standards along with the underpricing of risk, with the inevitable losses for the taxpayer.[7] In housing finance, the track record of unhealthy political influence is very well established.[8] My recommendations below do not, I believe, unduly reflect political considerations; instead, they are designed to be credibly respectful of the taxpayer's interests and also to support a stable financial system.

The Impact of Subsidies: A Higher Homeownership Rate vs. Higher Home Prices

Almost any program to increase the homeownership rate (e.g., reducing income taxes via the mortgage interest deduction) will of necessity tend to increase the demand for owner-occupied housing, which in

[7] Examples of such distortion outside of housing finance include the federal student loan program (the true economic loss of which is currently estimated to be in the range of $300 billion or more), the federal flood insurance program (with a deficit of $20 billion even after Congress cancelled $16 billion of debt it owed), and the pension benefit guaranty program (current deficit, net, $48 billion).

[8] For example, the actions of the Federal Home Loan Bank Board in the 1980s fit that characterization (e.g., allowing major undercapitalization of regulated thrifts), and the resulting S&L Crisis of 1989 shows how the taxpayer can end up with the losses (see Part 1 for more on this). Similarly, the regulation of the two GSEs in the 2000s prior to the financial crisis (also allowing major undercapitalization) fits that characterization.

turn can also feed into an increase in the price of housing.[9] Such a fluctuation in price is the basic economic mechanism by which supply and demand come into balance. What is unclear is the mix that will result from any specific government subsidy program: how much will the additional demand feed into a house price increase versus how much will it raise the homeownership rate?[10] This mix is something to consider when one designs policies to increase homeownership, with the best policies, of course, being those that most increase the homeownership rate while causing the least inflation of house prices.

In my view, two factors will be important in determining the balance between an increase in the homeownership rate and house price inflation that will result from any particular policy. First, the more targeted the program is, the more it will result in an actual increase in the homeownership rate rather than more generally pushing up the price of housing. My recommendations below are very much based upon strong targeting, especially much better targeting of today's existing large subsidies (which could then as a collateral benefit actually lead to a net reduction in the pressure for house price increases). Second, the faster and more easily the homebuilding industry can respond to an increase in demand for housing by producing more houses to own, the more that increased demand will also result in an actual increase in the homeownership rate rather than mainly in house price increases.[11] Right now, the ability to build more homes in response to an increase in demand is, unfortunately, very unfavorable with a decade-long construction shortfall, which is why I have considered it so important to address the topic later in this paper.

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[9] As an example, the federal student loan program is often accused of leading to an increase in the cost of higher education, where the average college tuition has risen faster than general inflation for roughly five decades. For a recent discussion of this topic, see Melissa Korn and Andrea Fuller, "Financially Hobbled for Life: The Elite Master's Degrees that Don't Pay Off," *Wall Street Journal*, July 8, 2021, https://www.wsj.com/articles/financially-hobbled-for-life-the-elite-masters-degrees-that-dont-pay-off-11625752773.

[10] I have found that, in the highly politicized environment of housing finance policy, this concern is treated in a similarly highly politicized manner, with members of the policy community on the political right biased to claiming all or almost all of the impact of any housing subsidy program goes to house price increases while advocates on the political left generally have historically downplayed or ignored the impact on house prices as if it did not exist. I note, however, that recent high house price inflation is making even those on the political left sensitive to this issue.

[11] Economists would refer to this – the degree to which a price increase in homes will quickly generate significant new construction in response – as the elasticity of the construction of new homes. If the elasticity is high, subsidies to FTHBs would not turn primarily into an increase in house prices; if low, they would.

Economic Growth Matters, Especially for Median-Income Households

The 130-year history in Part 1 shows clearly that the homeownership rate can be pushed higher or lower a few percentage points by how well the overall economy is doing, especially as it impacts the more typical median income-range household that plays such a key role in whether more or fewer families can afford to become first-time home buyers (FTHBs). This was true on the positive side, for example, in the Roaring Twenties as well as during the President Clinton-era economic boom in the 1990s. The early 1930s, the beginning of the Great Depression, showed the impact on the downside. Naturally, every president promises that his policies will deliver just such growth and advancement, but the historic evidence is otherwise.

Unfortunately, real median household income has lately been going in the wrong direction: it not surprisingly declined in 2020 by 3 percent due to the pandemic-related economic contraction, and it is expected to shrink again in 2021, mainly due to the highest inflation we've seen in decades. This is not a good start to pushing the homeownership rate up during the next four to five years.[12]

Because so many unprecedented factors are in play right now in terms of the economy – the residual impact of the pandemic and its associated large government rescue spending, monetary policy that has been ultra-loose, inflation that we have not seen in decades, and tax and spending bills of extraordinary size (some passed into legislation, some still being considered) – there is no clear trend to how median household income, which I believe is key to the homeownership rate, will likely go during the next few years.

Protecting Against the Downside: Completing Housing Finance's Safety and Soundness

We all learned in the financial crisis of 2008 how financial institutions that are not operating in a safe and sound manner, especially by being allowed by their regulators to be undercapitalized, can then hurt the real economy – including the homeownership rate, which declined from its bubble-induced level of about 69 percent from 2004 to 2006 to its recent low of 62.9 percent in 2016's second quarter.[13] So,

[12] Interestingly, during the Trump administration – at least until the pandemic showed up – real median household income grew strongly, as it was up 3 percent per annum for the first three years of his term (although as economic trends don't fit neatly into presidential administrations, some argue this trend started in the latter years of the Obama presidency). The homeownership rate went up by 1.2 percentage points during the first three years of Trump's term, which is a decently strong showing. It is unclear, of course, how long-lasting this trend in income or homeownership rate growth would have been if the pandemic had not arrived.

[13] See "Homeownership Rate in the United States," Federal Reserve Economic Data via the St. Louis Federal Reserve, https://fred.stlouisfed.org/series/RHORUSQ156N.

while ensuring that the housing finance system is fully safe and sound won't make the homeownership rate higher, it will absolutely guard against some stress event taking it down a lot lower.

The safety and soundness of the housing finance system is not a theoretical worry, either. As a reminder: after the rebuilding of the system from 1930 through the early 1960s, it suffered repeated episodes of damage to its safety and soundness. First was the S&L Crisis of 1989, when the dominant thrifts proved incapable of dealing with high interest rates, for reasons including their undercapitalization. Then, in 2008, we saw that the GSEs, which had replaced the thrifts as the dominant mortgage credit source, were unable to deal with a downturn in credit performance due to their overconcentration of mortgage credit risk along with, again, undercapitalization.

Today, there is still unfinished business in ensuring that safety and soundness. In particular, the two GSEs are still undercapitalized (instead relying unduly upon special government support for their creditworthiness). It is therefore very important for them to be able to continue retaining earnings, which they began to do in 2019, to build that capital, even though they remain in conservatorship. Additionally, to reduce the GSEs' systemically risky concentration of mortgage credit risk, the program to lay off a major portion of that concentrated risk via credit risk transfer (CRT) transactions is key and so should be vigorously pursued.[14]

Racial Discrimination in Housing and the Broader Economy

Historic and current racial disparities, including in housing, are a topic very much on the front burner in Washington. Historic discrimination significantly explains where we are today, with large racial gaps in income, family wealth, and the homeownership rate; to eliminate current disparities, we must understand how to design programs that reduce those racial gaps. I note that some of these programs will directly concern housing and housing finance markets – but some will not, as they will focus on broader economic racial disparities, such as in median household income or household saving, that in turn significantly influence how much those homeownership rate gaps will close. I believe that those gaps can be fully addressed only by looking at policies outside of the field of housing and housing finance as well as in it. As I understand it, the Biden administration has prioritized such issues, with

[14] The single-family CRT program began in 2013 and quickly became a standard component of almost all GSE home loan purchase activities. Unfortunately, FHFA decisions during 2019 and 2020, under then-Director Mark Calabria, reduced the incentive for the program to proceed and it naturally began to be less important to GSE operations. Those decisions have largely been reversed since his departure in mid-2021, and the usage of CRT is quickly returning to its previous importance.

Marcia Fudge, as secretary of the Department Housing and Urban Development (HUD), taking the lead on housing-related ones.

As mentioned above, as the non-Hispanic white homeownership rate is already high, the opportunity to increase the national average homeownership rate is concentrated in successfully reducing racial homeownership gaps. Reducing these gaps is, simply put, where the leverage is. That's why it is so important to understand those gaps and what it will take to reduce them.

Homeownership Subsidies: Re-Targeting Two Large Ones Plus Adding Another

Subsidies (including cross-subsidies) related to homeownership are a well-established fact of economic and political life in America – they are large and come in both overt and hidden form.[15] If done well, such subsidies are at least justifiable by their effectiveness. Historically, however, they have often not been that well designed or effective, in my view often having very poor targeting. To fight a downturn in the homeownership rate at this time, and then to hopefully raise it significantly in the longer term, the core recommendations in this paper are (1) to heavily re-target two large existing subsidies in order to reduce monthly payments for borrowers who need the help to first purchase and then sustain ownership of a first home, and then (2) to add a new on-budget subsidy, inspired by the 2020 Biden campaign's proposal on downpayment assistance (DPA), to reduce the need for a downpayment for another carefully targeted set of borrowers.

In terms of the targeting for all three subsidies, a core objective is to aid families that are close to being able to afford homeownership get over the finish line to graduate from being renters. One way to roughly define such a target audience is based upon household income relative to the median, which in pre-pandemic 2019 was $68,700 per annum; those with income above that level had a very impressive 78.8 percent homeownership rate, while those below the median had a comparatively paltry 51.4 percent.[16] On that basis, the targeted household income for homeownership subsidies should broadly be in a range centered upon the median.[17] As discussed below, other criteria can and should then be added to achieve the kind of impactful targeting I believe is called for.

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[15] I have included cross-subsidies as, to the recipient, they are just a subsidy. They are "cross-subsidies" (as explained below in terms of the mortgage agency interest rate cross-subsidies) because other borrowers fund them as a hidden tax, rather than overtly using federal budget dollars.

[16] These figures are from the Census Bureau's "Quarterly Residential Vacancies and Homeownership" for 2019 Q4, Table 8, https://www.census.gov/housing/hvs/files/currenthvspress.pdf.

[17] I have found there is often a focus on the band of from 60 or 80 percent to 120 percent of the area median income (AMI) for various types of housing-related subsidized initiatives. So, this approach is well established in housing policy already, and takes account of geographic differences in income levels. The targeting could be made

Mortgage Interest Deductibility: Redirecting Subsidies Towards the Median-Income Family[18]

Lest we forget, it has long been understood that the tax deductibility of mortgage interest is the largest subsidy to homeownership – the proverbial 600 pound gorilla of the field.[19] This subsidy was valued some years before the pandemic at about $50 to 60 billion per year, several times the value of the other subsidies described below.[20] More recent estimates, reflecting slightly lower top marginal income tax rates, record-low mortgage interest rates, and in particular a more generous standard deduction so that fewer people itemize, are in the range of $25 billion per year – lower, but still several times the value of other subsidies.[21]

It has also long been known that the mortgage interest deduction is absolutely regressive, as it is a deduction rather than a credit. In fact, it is doubly-regressive. First, wealthier families – with on average more expensive homes and bigger mortgages – have larger interest payments to deduct; second, they have a higher marginal tax rate to shelter that larger dollar amount.[22] As a result, in 2018 taxpayers earning under $50,000 per year received under 1 percent of the tax benefits of the deduction, while those earning over $200,000 took 60 percent of those benefits. This is simply awful targeting.

In addition, I would say it is conventional wisdom in public finance circles that the mortgage interest deductibility we have today is not just regressive, but also does not really increase the homeownership rate, as the benefits go so overwhelmingly to families with income well above the median who are thus very likely already homeowners (or would be without government help). Instead, that conventional wisdom concludes that a main impact of this indirect subsidy is therefore to raise the cost of housing above what it otherwise would have been[23] (especially for houses that cost more than

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more sophisticated and accurate by varying the band to also reflect how local median house prices relate to AMI (as is sometimes already done in existing programs for very high-cost urban areas such as New York City).

[18] The tax deductibility of property taxes was a source of additional subsidy, but has been severely cut back by the recent limitation to $10,000 on all state and local taxes. I therefore do not include it in this discussion. Possible legislation may restore this subsidy to much higher levels.

[19] For a good summary, see Scott Eastman and Anna Tyger, "The Home Mortgage Interest Deduction," Tax Foundation, October 2019, https://taxfoundation.org/home-mortgage-interest-deduction/.

[20] This figure is based upon the US Treasury estimate of tax revenue being reduced, as cited by Eastman and Tyger, by $597.5 billion for a ten-year budget planning horizon.

[21] See Congressional Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024," p. 26, Table 1 (Deduction for mortgage interest on owner-occupied residences), https://www.jct.gov/publications/2020/jcx-23-20/.

[22] This reference to wealthier families is about the upper middle class. As there is currently a limit of $750,000 on the amount of a mortgage upon which interest can be deducted, the very wealthy who have very large mortgages (many will own their houses without a mortgage) cannot benefit beyond the $750,000 level.

[23] Again, see Eastman and Tyger, "The Home Mortgage Interest Deduction."

the median), an increase which, as collateral damage, will even push the homeownership rate down to some degree. I agree with these points.

Because of the immense size of the subsidy and how badly it is targeted, I have made it the first priority of my recommendations to very substantially revamp its targeting, while keeping the impact on the federal budget unchanged (i.e. there would be no increase or decrease in the value of the subsidy). Done well, this retargeting of the existing amount of subsidy may in fact somewhat reduce the pressure it puts on house prices – a collateral benefit to my proposal.

First, it will be necessary to at least convert the deduction to a credit so it can significantly benefit the targeted near-median-income household.[24] A recommendation of how to do that by a 2005 report on tax reform to the administration of President George W. Bush is a good place to start.[25] It called for a 15 percent tax credit, with certain limitations. For a typical near-median-income FTHB carrying a mortgage with a 4 percent rate (not so low as today's near-3 percent rate, which historically is not likely to last), the current deduction would probably be worth zero, as such a potential new homeowner would most likely not be itemizing deductions. Under the Bush tax reform commission's 15 percent tax credit proposal, the tax credit would be worth a 0.60 percentage point offset to the 4 percent interest rate, creating a net 3.40 percent interest rate. In dollar terms, on a $200,000 mortgage appropriate for a typical starter home purchase, that offset would save about $1,200 in the first year, a decent but not strongly impactful amount. In fact, the 15 percent tax credit approach recommended by the commission is still regressive, allowing a much bigger credit for wealthier families with their, on average, larger mortgage interest payments. In other words, the recommendation by the commission has only taken a doubly regressive impact and made it singly regressive.

Therefore, to help offset that remaining regressiveness, I would suggest policymakers look at a *graduated* tax credit rate as one example of how to better target the subsidy, starting at maybe 30 percent on smaller amounts (increasing that $1,200 per annum benefit to more in the range of $2,400, a considerably more impactful amount) and then decreasing in steps down to 10 or 15 percent, and then

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[24] For maximum impact, the credit could be refundable, so families receive it even if their income tax liability is not large enough to absorb it.

[25] See the report of the President's Advisory Panel on Federal Tax Reform, established in 2005 during the administration of President George W. Bush, https://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_5-7.pdf. It recommended the deduction be converted to a 15 percent credit with certain limitations (and which I saw then completely ignored by the administration and Congress due to the politics); see especially p.61 and p.70-75. Also, the report notes that the value of the tax subsidy to housing is greater than the entire budget for the Department of Housing and Urban Development (HUD).

further down to zero at some point.[26] This graduated tax credit would give a bigger bang for the buck to median income-range homeowners, which would disproportionately include FTHBs who are not high earners.

Nevertheless, the politics surrounding the mortgage interest deduction are fierce, and attempts to either eliminate it or even convert it to a credit (to make it less regressive) have therefore largely failed in the past.[27] At present, though, those politics could very well be somewhat fluid for four reasons. First, given the unprecedented windfall to wealthier homeowners from the (so far) over-25-percent increase in house prices in less than two years of the pandemic, it is hard to argue those families need a large regressive subsidy to continue unabated. Second, recent ultra-low mortgage rates have created a refinancing boom, so existing homeowning families have a second windfall via much lower monthly payments. Third, with recent increases in the standard deduction and today's lower interest rates, not that many taxpayers itemize, which is of course necessary to get the benefit of the current mortgage interest deduction; a recent estimate is that under 10 percent of tax filers do, so the electoral penalty from revising the current treatment would be relatively low.[28] And fourth, with the heavy focus on racial homeownership gaps in policy and political circles at this time, the subsidy going so overwhelmingly to white homeowners (who disproportionately comprise the higher-income families who receive so much of it currently) could produce new political flexibility. Of course, a transition period would be needed as current homeowning families have built their monthly budgets to include today's doubly regressive deductibility – the Bush task force called for five years, but I think ten is more politically palatable.

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[26] The graduated tax credit concept is just one way to more carefully target who receives the mortgage interest subsidy dollars. There are likely other reasonable ways to do so as well, and it is impossible to predict which would be most likely to get through the political process to ultimate approval.

[27] Industries that benefit from the subsidy (e.g., homebuilders, real estate brokers) are found in every congressional district and are well organized to defend their interests. I personally heard one representative from these industries, in 2017, state that the only change the industry would agree to was a further reduction in the maximum amount to which it could be applied – and the ultimate result was a reduction in that limit from $1,000,000 to $750,000. This change does nothing for increasing the homeownership rate, although it does reduce some of the welfare-for-the-rich aspect of the deduction. Separately, converting the benefit so it went to a narrower (i.e., carefully targeted) group of beneficiaries could well create political problems for elected officials, who arguably like broadly spread subsidies to benefit more voters rather than fewer.

[28] See Congressional Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024," Table 2.

Downpayment Assistance: Biden-Campaign-Inspired Proposals Have Real Potential

It is also conventional wisdom in housing finance policy circles that coming up with a downpayment is probably the biggest barrier to qualifying for homeownership.[29] So, the notion of a program for downpayment assistance is nothing new. As described in Part 1, there are literally thousands of such programs, each with its own size, structure, and so on. This chaotic array of programs is widely considered not very effective.

During the recent presidential election, the Biden campaign released a document entitled "The Biden Plan for Investing in Our Communities through Housing." It was a soup-to-nuts listing of many proposals, printing out at about 25 pages. One item, taking up just one third of a page, was to create a $15,000 tax credit for first-time home buyers that was not just refundable (i.e., you received it even if you didn't pay that much in income tax) but also advanceable (i.e., it was available at a home purchase closing, not received months later after the filing and processing of a tax return). This proposal has simply upended the thinking in the field.

I am very supportive of the core components of the Biden campaign proposal. First, whereas the recommendation above concerning the mortgage interest deduction reduces the monthly mortgage payment for targeted families, the Biden proposal complements that assistance by reducing the downpayment requirement for the targeted families. At $15,000, the proposed credit is generous compared to almost all of the thousands of other DPA programs in America, and the proposal also burst through several orthodoxies that, it is clear to me in retrospect, had hemmed in housing policy thinking on the topic for decades. This proposal seems to have made it acceptable among housing advocates and in Congress (at least among Democrats) to also ignore those orthodoxies, unleashing new proposals that are, in my view, very welcome.

The Biden campaign proposal ignored prevailing orthodoxies in three key ways, and it is important to understand the importance of these breakthroughs.

First, it uses funds from the federal budget. As described in Part 1, the thousands of current downpayment assistance (DPA) programs are dominated by small dollar amounts, mostly in the

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[29] For example, see Ellen Wilson and Robert Callis, "Who Could Afford to Buy a Home in 2009? Affordability of Buying a Home in the United States," US Census Bureau, 2013, esp. p. 6, Table 5, https://www.census.gov/content/dam/Census/library/publications/2013/demo/h121_13-02.pdf. Wilson and Callis conclude that cash downpayment assistance had the greatest potential to improve the homeownership rate. On a more anecdotal level, early in my tenure at Freddie Mac, I met with the head of a major civil rights organization. He emphasized over and over to me how hard it was for the typical African American family, with its on-average lower income, to save for a downpayment, and how this difficulty was the single biggest barrier to homeownership.

form of subordinated loans being placed on top of high and ultra-high loan-to-value (LTV) mortgages. In discussions with housing finance policy specialists, I learned this design was part and parcel of an overall strategy (similar to unfunded mandates and cross-subsidies) to stay away from the federal budget. I learned that this strategy was based upon fear that any budget-based programs would be eliminated when Republicans were in charge of Congress and/or the White House.[30] Unfortunately, this strategy has meant in practice that DPA programs have been limited in impact. The Biden campaign's proposal just brushed this strategy aside since, being in the form of a tax credit, it was fully on the federal budget. I regard this as a real positive: while being on-budget may be riskier in terms of longer-term political exposure, it can provide a larger amount of targeted funding that will, hopefully, lead to a significant increase in the homeownership rate.

Second, it provides cash equity rather than more debt. The Biden campaign proposal is for a significant amount of money – up to $15,000 per beneficiary – in the form of equity. This contrasts strongly with the typical current DPA program, which usually calls for small amounts of subordinated debt on top of an existing high-LTV mortgage. Such a highly leveraged condition means the borrowing family has not proven able to generate at least the modest level of cash savings needed to sustain ownership, and so the program can leave that borrowing family even more exposed.[31] To me, this is the very definition of an unsustainable program. The program's

[30] In 2014, I appeared on a Milken Institute housing reform panel with a just-retired senior Obama administration official. He told the audience that the proposed bipartisan housing reform legislation in the Senate, known mostly as Corker-Warner and supported by moderates in both parties and the Obama administration, had collapsed earlier that year because progressives in his own party would not support one specific feature of it. That feature was dropping the GSE affordable housing goals, which Republicans considered to be opaque and ineffective, and replacing that affordable goals program with a fee to be paid by the two companies to the government for use in housing programs. According to that official, he could not get the progressives to budge, despite his showing them numbers indicating that the fee would be worth multiples of the actual benefits historically delivered by the affordable goals program. Not understanding why this would be, I investigated the topic immediately afterwards, and learned that the progressives had no confidence that such an on-budget structure would last long, as Republicans (then the majority in Congress) could so easily change it at some point in the future.

[31] The typical DPA structure is in line with the longstanding orthodoxy that the difficulty of saving for a downpayment should be eased by severely reducing or eliminating the need for it. This view has taken the form of advocates pushing for ultra-high (i.e., over 95 percent) loan-to-value ratio mortgage loans: for example, at 97 percent at the GSEs, who have made modest amounts of such loans at the direction of the FHFA; at 96.5 percent at the FHA; and at 100 percent at the VA. Some housing advocate proposals have called for LTV to be up to 105 percent (so fees can be covered along with all of principal). These practices, I believe, have proven problematic: a family that cannot save enough for a modest downpayment (on a starter home, as little as $10,000) is likely to not be able to generate the cash savings needed to meet the unexpected costs that accompany homeownership (e.g., for repairs or an increased property tax bill), much less deal with an interruption to income or unexpected medical bills while continuing to make mortgage payments. In addition, for a family with little equity, any problem in making loan payments will be more likely to result in foreclosure than in an alternative.

unsustainable risks are exacerbated if one purchases a home at the top of the house price cycle – as happened to many families from 2005 to 2007. The Biden DPA proposal, by contrast, provides cash equity so that the LTV does not have to be so high (hopefully, in my view, not over 95 percent of the house's purchase price at closing).[32] The borrower will thus have better staying power to get through tough times and will be more likely to avoid foreclosure, as alternatives to it will become more viable. I definitely regard this as a positive policy move, as long as the cash equity in the Biden DPA proposal is used to create real equity (a minimum of 5 percent) in a home on day one (i.e., upon closing), rather than just being placed on top of an ultra-high LTV loan to, perhaps, mostly be used to pay fees. This type of DPA program could be impactful enough to generate a major improvement in the homeownership rate that is also sustainable.

Third, it distributes subsidies directly to the beneficiary rather than through middlemen. America's housing finance system is well known for being heavily layered, with almost every function often passing through multiple hands (i.e., middlemen) between the borrower and the actual underlying provider of the funds (such as the GSEs).[33] I once witnessed a conversation between two government officials expressing considerable skepticism about whether any of the benefit of a proposed subsidy under consideration, which was to be provided through the GSEs, would in fact ever end up accruing to actual homeowners rather just enhancing the revenues and profits of the middlemen who operate between the borrower and the GSEs.[34] The Biden

[32] To avoid a loophole where a homeowner could receive the DPA subsidy and quickly turn around and sell a house, the assistance will require a feature whereby it fully kicks in only after perhaps 5 years or so. (There are various ways to do this.) My comment about equity on day one reflects counting the DPA amount as if it were pure equity, not recognizing the contingency that it might have to be partially or fully paid back if the homeowner sells the property without waiting the full number of years required. I also would probably include a feature whereby the DPA amount – the maximum of $15,000 specified in the Biden campaign proposal, but with other legislative alternatives going to $20,000 or $25,000 – should be no more than 50 percent of the total of the downpayment plus closing fees; this feature is designed to ensure that the borrower has demonstrated an ability to generate at least some cash reserves to sustain ownership through unexpected repair needs or other problems.

[33] Prior to the 1980s, when the thrifts dominated housing finance, there were fewer layers in the mortgage system, as the thrift lender dealing with the borrower was usually the holder and servicer of the resulting loan. But with the post-S&L Crisis rise of the four government agencies to largely replace them, though only as secondary market lenders, that feature changed. Between a borrower and the agency funding the loan could be one or more primary market lenders, there could be a separate servicer of a loan (which could change from time to time), and so on.

[34] An example of this would be the GSE affordable loan program. The GSEs require sometimes only a very low rate of interest on such loans. For those loans bought on a "flow" basis – meaning loans originated by primary-market lenders that qualify as affordable being quickly sold to a GSE – it is not unreasonable to assume that this GSE-provided low rate would mostly be passed through to the borrower by the primary-market lender. But many of the loans that count as affordable are purchased in "bulk sales" – sales of loans from many months or even years past that meet the criteria for being affordable. In such a case, there is no obvious linkage between the GSEs' low

DPA proposal bypasses all those layers: because it is structured as a tax credit, the subsidy goes directly from the federal government to the beneficiary, who presumably can then purchase their first home. I recently asked some ex-government officials (administrative, not elected) what they thought of a program that is direct to the beneficiary (e.g., akin to Social Security) rather than through various layers of government or private sector organizations. Their response was that it was obvious, at least to them, that every layer a program passes through increases funds being directed to overhead costs rather than to the intended beneficiaries, allows more political interference behind the scenes to distort or redirect funds, and dilutes accountability for program effectiveness at each step.[35] I also regard this direct-to-beneficiary feature positively, as it means the proposed program would be more likely to be efficient and properly targeted as the layers were minimized by the tax credit approach.

Naturally, the Biden campaign DPA proposal was so high-level that there were many details to fill in. As legislative ideas have been proposed and advanced, the leading DPA proposal became a part of the Build Back Better (BBB) bill, which as of this writing has an uncertain fate. This BBB DPA proposal features both an even more generous $25,000 maximum assistance amount and careful targeting: the recipient must be a "first-generation homebuyer" (FGHB), defined in the legislation to mean that the parents of the borrowers do not own a home (such homeownership being considered a strong proxy for family wealth).[36] In particular, I would watch for the following in whatever bill finally passes, if one ever does:

- Do the DPA dollars go to ensuring that the borrower, though having saved only a modest amount for the purchase, has significant equity in a home on day one (my target being at least 5 percent of the purchase price)?[37] Or, do too many of the DPA dollars

pricing and the origination of the loan (perhaps years earlier). In this latter type of situation, I see the GSEs' subsidized pricing primarily benefitting the primary-market lenders involved, and not the underlying borrower.

[35] I note that elected officials might have the opposite view: the many layers present more opportunities to reward supporters, direct funding towards politically advantageous projects, and generally build influence. While this layering would be at the expense of the program's effectiveness, to an elected official that effectiveness might be less important than helping to increase their political influence and probability of getting re-elected. This is a reminder how government programs reflect politics as much as well-designed policies.

[36] A recent draft of the bill can be found at https://financialservices.house.gov/uploadedfiles/bills-117pih-downpaymenttowardequityact.pdf. It shows that there are quite a few dimensions to the targeting, making it the most careful attempt of which I am aware.

[37] Without going into all the details, the BBB DPA legislation for starter homes is fully compatible with a 5 percent equity upon closing while only burdening the FTHB with a downpayment requirement that is quite modest – e.g., $10,000 – and is really the minimum necessary, in my view, to show an ability to generate the cash savings needed to then sustain homeownership on a long-term basis.

end up paying for fees of various types (which may well begin to rise to meet the availability of the cash to pay for them)?

- Does the program maintain the direct-to-beneficiary design? Housing advocates almost instantly dismissed the tax credit distribution by the IRS as being non-implementable, which may be the case. As a backup, a simple distribution system of using solely each state's housing finance agency (HFA) might serve adequately. But the latest version of the legislation has a complex clause permitting many other organizations to act as distribution agents as well.[38]
- Is the program well targeted at FTHBs who, while close to qualifying for a mortgage to purchase a home, come from low-income/low-wealth backgrounds – that is, at the very people who need the help to become homeowners? Helping them is at the core of the whole concept.[39] If done well, this targeting would disproportionately help Black and also Hispanic families (see below for more on this).

I also note that the aggregate dollar amount of such help was not specified in the Biden campaign proposal. Numbers as high as $100 billion over ten years (i.e., about $10 billion per year) have been discussed in Congress, but as of this writing much more modest amounts are included in the BBB legislation (currently, $10 billion over 5 years), so again it is totally unclear what might actually result, or indeed if anything will result.[40]

However, whether now or later, such assistance is going to be needed, especially given how much the price of housing has increased during the pandemic. As long as actual legislation that evolves from the Biden campaign proposal for generous downpayment assistance sticks fairly closely to the proposal's intended design, I am highly supportive. Unless the government puts something akin to it in

[38] The eligible institutions listed are, not surprisingly, very Democratic Party-aligned, as are certain other details of the bill. This reflects its one-party orientation. A bill designed to attract bipartisan support would likely have somewhat different features.

[39] Not even close to all FTHBs deserve any special subsidy to purchase a home, as they can have considerable family wealth behind them or may be well educated with excellent career earnings prospects to come. Thus, the targeting has to be very intentional. The BBB DPA legislation, in my view, does a credible job of such targeting – aiming at FTHBs who are also first-generation buyers (i.e., their parents do not own a home) and have income no higher than 120 percent of AMI (or 140 percent in high-cost areas), among other limitations.

[40] The downpayment assistance program, being part of the highly partisan and controversial BBB legislation, is now tainted as being partisan as well. I am of the personal opinion that a well-crafted, stand-alone DPA bill could get bipartisan support (like the just-passed infrastructure bill), but because it has been included as part of BBB, it is unclear if such bipartisanship can be recovered without a long cooling-off period – and of course it would also require dropping the bill's partisan features.

place, increasing the homeownership rate, or even fighting a near-term decline, will probably be impossible.

Today's Hidden Mortgage Interest Cross-Subsidies: Significantly Improving the Targeting

While downpayment help is regarded by housing policy specialists as the best leverage point to increase the homeownership rate, some of the fiercest debates about housing policy nevertheless focus on keeping the interest rate on mortgages as low as possible, including for targeted groups. This focus is reflected in the politics around the mortgage interest deduction, as discussed above, and also via continuing political pressure on the GSEs[41] to reduce their guarantee fees, especially for groups of borrowers that housing advocates identify as worthy of help.

I do not think it broadly known how much the four government housing finance agencies (mostly via Freddie Mac and Fannie Mae, with the FHA and VA playing very secondary roles), *already* have large cross-subsidies that impact the interest rate on mortgages.[42] These subsidies, in one way or another, require certain borrowers to pay an interest rate *above* what the riskiness of their loan would require in order to generate a subsidy pool which is then distributed by allowing other borrowers to pay an interest rate *below* what the riskiness of their loans would require.

There is a considerable lack of knowledge and understanding about these cross-subsidies not only because they are a technically complex topic but also because there is little transparency about how they work, how much they are, which borrowers provide the subsidies and which ones receive them.[43] In fact, my view is that the cross-subsidies do not fully result from carefully calibrated programs to target deserving borrowers, but rather from a variety of policies and traditions put together at different times, and so they sometimes make less policy sense than is desirable. As a result, I find the cross-subsidy programs to be inadequately targeted in general and in need of significant reform.

For example, FTHBs are not a designated category in the core (and large) cross-subsidy programs and thus do not get any overt special subsidy benefit directed their way, although they do benefit from subsidies generally along with other borrowers, and they do benefit from certain specialty programs. FTHBs should be such a designated category, in my view, if the subsidies are to be allocated

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[41] There is also similar pressure on the FHA to reduce its pricing, in particular at times (like right now) when it reports it has strong reserves, as calculated and disclosed annually.

[42] The four agencies have recently accounted for a pandemic-enhanced 75 percent range of new mortgage lending.

[43] A just-published report from the FHFA, "Fannie Mae and Freddie Mac Single-Family Guarantee Fees in 2020," https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/GFee-Report-2020.pdf, does have some transparency on the cross-subsidies, although in the indirect form of information concerning how returns on the guarantees vary versus a defined target cost of capital.

strategically to get the best social benefit; as in the downpayment assistance targeting described above, the FTHBs most in need of assistance should be most targeted.

While the two GSEs, FHA and VA are all generally referred to as the "mortgage agencies," the two GSEs have very different structures from the FHA and VA. Specifically, the former are shareholder-owned private companies that enjoy certain government support, albeit currently being under temporary government control; in contrast, the latter are directly units of the US Government, enjoying the full faith and credit of the United States. These different structures affect how their cross-subsidies work. As a result, I will first examine the main cross-subsidy program of the two GSEs, the largest players in the mortgage system, which are far larger and about which more is publicly known. Following that, I will describe more cursorily what is done at the FHA, which has a smaller mortgage program about which there is less public information available.

The Two GSEs

As stated above, the two GSEs engage in a complex system of adjusting the pricing of a mortgage purchase, using a schedule set by their conservator, the Federal Housing Finance Agency (FHFA), starting about a decade ago, in response to legislation requiring the GSEs to use private-sector style pricing, which has been interpreted by the FHFA to mean pricing that reflects risk.[44] Today, these adjustments (called loan-level pricing adjustments, LLPAs) first reflect what is required for the credit risk of a specific purchase.[45] That's totally fair and is a universal practice among shareholder-owned banks and other lenders.[46] But, in addition, the adjustments also implicitly include an amount (which translates into a higher interest rate to be a source of subsidy, a lower one to be a beneficiary) to reflect a system of cross-subsidies that, as explained below, is surprisingly large in aggregate. Since the marketplace only sees the sum total of the two adjustments, there is effectively no detailed transparency as to how much of the LLPA for any particular loan is the credit risk component and how much is the cross-subsidy

[44] The first adjusting of pricing actually began in 2009, when the two GSEs added to their pricing in various ways to help generate income to make up for all the losses they were incurring in the early years of the mortgage bubble bursting. The motivation for the FHFA first setting the cross-subsidies in response to legislation was personally recounted to me by Edward DeMarco, then the acting Director of the FHFA, who oversaw their development and implementation. The adjustments have been modestly and infrequently revised since.

[45] For technical reasons, the pricing adjustment is in the form of up-front fees charged to primary market lenders by the GSEs, rather than actual interest rate adjustments. To the ultimate borrower, it shows up as a simple interest rate adjustment.

[46] If banks did not so adjust their pricing for the credit risk, I believe their regulators would find that to be an unsafe and unsound practice, as it would result in at least some part of a "death spiral" as the lender would attract an undue share of the underpriced high-risk loans and too little a share of the overpriced low-risk loans.

component. In my view, the most recent and detailed study to penetrate this lack of transparency is a 2019 article by Michael Stegman and Richard Cooperstein that utilized data from 2016.[47]

The article, utilizing mainly publicly released loan-level data from the two GSEs, takes each GSE mortgage purchase price total adjustment and then subtracts what the authors calculate to be the proper portion for credit risk, leaving as a residual a reasonable estimate of the cross-subsidy.[48] It then analyzes those cross-subsidies by various categories. The Stegman and Cooperstein article generates some findings that are not well known, but should be. Specifically:

1. The total value of the cross-subsidy pool is reasonably large, about $2.5 billion per year.[49] This is a tremendous amount of value, and it should be a high priority to make sure it is thoughtfully targeted. (I note an earlier article, based upon less detailed data analysis, estimated the subsidy to be even larger, at about $4 billion per year.[50])
2. The source of this cross-subsidy pool comes mostly from two products: investor loans and cash-out refinancings, which account for about 90 percent of the funding.[51] This is counter to the general notion held by some in the industry and the policy community that the subsidy source is primarily lower-risk loans in general, which in fact generate only about 10 percent of the total subsidy pool.

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[47] See Michael Stegman and Richard Cooperstein, "A Missing Piece of the Administrative Reform Puzzle: How the GSEs Generate Cross-Subsidies," Harvard Joint Center for Housing Studies, October 2019, https://www.jchs.harvard.edu/research-areas/working-papers/missing-piece-administrative-reform-puzzle-how-gses-generate-cross.

[48] Beginning in 2013, the two GSEs began to release very detailed credit risk data to support their credit risk transfer programs, which first began that year. Until that time, not enough data was publicly available to do the type of analysis done in the Stegman-Cooperstein article.

[49] If this were a federal budget item, where amounts are measured over 10-year planning periods, it would amount to about $25 billion in total. However, it is unclear how stable the size of the subsidy pool is from year to year. This is an area for further research. I also note that there were beginning in late January 2021 certain recent restrictions reducing the volume of investment properties purchased by the GSEs, which could be impactful – but those restrictions were temporarily lifted in September 2021.

[50] See Jim Parrott, Michael Stegman, Phillip Swagel, and Mark Zandi, "Access and Affordability in the New Housing Finance System," Urban Institute, February 2018, p. 1, https://www.urban.org/sites/default/files/publication/96461/access_and_affordability_in_the_new_housing_finance_system.pdf.

[51] These products are regarded in housing finance policy circles (and I agree with this view) as having less social value than other types of mortgage loans, and so it is no surprise that they are "priced up" to generate the cross-subsidy, as doing them is really an accommodation to primary-market lenders. Curiously, second home and jumbo loans are not so priced up; they seem very conspicuous by their absence. Also, note that investment, second home and jumbo loans cannot be done in unlimited volume due to certain restrictions related to the MBS market.

3. The beneficiaries of the subsidy pool are higher-risk borrowers, as is expected, and most benefits go to borrowers with a loan size of under $400,000, as is also expected.[52]

As stated above, *I view the targeting of this cross-subsidy program as needing significant reform.* In particular, the whole program today is predicated on high-risk loans being worthy of subsidization on a blanket basis. That premise is rather questionable. As pointed out in the Stegman-Cooperstein article, the Federal Reserve did a study that concluded that "credit score distributions of high- and low-income consumers are both widely dispersed," and thus "income is not a strong predictor of credit scores, or vice versa."[53] In fact, this study confirms common sense: high-risk loans can include higher-income families who just run their finances irresponsibly (e.g., overspending via credit cards) or who just decide to borrow as much government-subsidized mortgage principal as possible instead of making a downpayment that they can afford. High-risk loans would also not always include middle- and low-income families who are commendably conservative in their finances.

I therefore believe the GSE cross-subsidy program needs a significant revision to have both its sources and its beneficiaries consciously engineered to improve the targeting of the social benefits delivered.

Sources: The typical GSE borrower who falls squarely within their core mission, should not, in my view, have to pay a hidden tax in the form of being a source of a cross-subsidy.[54] Such sources should include only products that are "mission-remote" (a term used at the FHFA): investor properties, second homes, cash-out refinancings and possibly jumbo conforming loans. Such products would be "priced up" to generate the subsidy, extrapolating further what already mostly exists today – and the analysis above shows it is already significantly in place and working quite well.

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[52] The subsidy is allocated somewhat erratically among the many categories of higher-risk borrowers. I do not believe this was intended by the FHFA when it set the rules for loan pricing; it is rather just a reflection of simplifications done for ease of implementation. It should be reconsidered as part of a revising the subsidy pool's targeting.

[53] Rachael Beer, Felicia Ionescu, and Geng Li, "Are Income and Credit Scores Highly Correlated?" *Fed Notes*, August 13, 2018, https://www.federalreserve.gov/econres/notes/feds-notes/are-income-and-credit-scores-highly-correlated-20180813.htm.

[54] As a reminder, the GSEs were designed to serve the middle and working class, as there is a congressionally defined limit on the size of mortgages they can purchase (the conforming loan limit). In that sense, almost all GSE borrower are defined as not "the rich" in legislative terms. Some housing advocates like the idea that conforming borrowers who are not "low to moderate income," however one defines that, would be a source of subsidy, but my view is that this is not needed given the ability of the mission-remote products to generate a large subsidy already

Beneficiaries: The targeting of beneficiaries should not be purely risk-based; such an approach is, as I've argued above, inadequate. Instead, benefits should be targeted at FTHBs from a low-income/low-wealth background. There are many ways to define that background: according to family income relative to area median income (a definition used in other mortgage credit programs), or according to whether one is a first-generation homebuyer (i.e., one's parents never owned a home, a proxy for measuring family wealth), etc. Furthermore, cross-subsidized loans should be available only for modestly priced homes.[55] This is an area for FHFA research, possibly including public input, to define who should be the beneficiaries of the subsidies, which should be designed (1) to help the homeownership rate (where being an FTHB is key) and (2) to also help the most economically deserving in general (where AMI and family wealth measures are appropriate).[56] Depending upon how narrow the targeting is, the impact on the typical interest rate could be material – i.e., a possible reduction of 0.10 to 0.20 percentage points per annum, maybe more. (This reduction would be on top of the larger interest rate offset from the recommended graduated tax credit on mortgage interest, as described above. The total of the two could possibly be 0.50 percentage points or more of the interest cost for many FTHBs.)

I note that this revision can be implemented administratively by the FHFA in a relatively short timeframe. It can also be done consistent with the overall returns from the single-family mortgage business being adequate for the taxpayer to get a fair return on its conservatorship-era investment in and exposure to the two GSEs (which would eventually become a fair return to shareholders if and when the GSEs would be privatized), all while targeted categories of borrowers (the cross-subsidies' beneficiaries) produce a considerably lower return, a concept already included in the charters of the two GSEs.

FHA and VA

The other two government agencies, the FHA and the VA, accounted for 20 to 25 percent of new mortgage flow in the years immediately prior to the pandemic, but for only about 15 percent more

[55] For clarity, as the US has no central registry of land ownership (and not for each of the 50 states either), it is very difficult to determine the accuracy of FTHB status. So, current government rules define a FTHB as someone who has not owned a home in the last three years – which is much easier to verify with reasonable, if not perfect, accuracy (and so there is no reputation of significant fraud in such claims). The accurate identification of first-generation homebuyers would be similarly challenging.

[56] This is a well-targeted and net-zero cross-subsidy approach, i.e. while some borrowers will end up being advantaged, other borrowers will be somewhat disadvantaged. This helps reduce the impact of the subsidies on house prices.

recently. Focusing on the FHA alone (so as to avoid the issue of veteran benefits involved in VA mortgage activities), it is first worth remembering that the entire structure of the FHA is designed to be heavily subsidized. It does not have shareholders' equity, and thus does not require a return on that equity to be a component of the pricing of its mortgage insurance. Its borrowers get interest rates that are based upon mortgage-backed securities that enjoy a guarantee backed by the full faith and credit of the US – which means they have lower rates than similar GSE securities, usually by at least 0.10 percent – and for which the agencies pay the taxpayer zero. With this heavy subsidization, then, the FHA in a sense has the same raison d'être as downpayment assistance or other subsidy programs: to get those families who are close to being able to afford homeownership across the finish line, allowing them to actually own a home.

While the FHA should also look to make its cross-subsidies transparent, the reality is that revising the targeting by the GSEs will produce much more value, while the upside for doing so at the FHA is comparatively limited. The agency already reports that the vast majority of its purchase loans are to FTHBs, heavily to what it calls "underserved" and borrowers of color in particular, and it has few mission-remote products that can be used to generate a large subsidy pool.[57] So, my recommendation would just be to develop the transparency and then see if something of impactful size can reasonably be done through improved targeting.

Attacking the Shortfall of New Home Construction

It has been debated for decades how much the various subsidies to housing – in particular the mortgage interest deduction – translated into increased homeownership versus increased house prices. The answer was not always clear. But with the massive shortfall in construction of new homes starting in about 2016 (as discussed immediately below), it has become crystal clear that the answer today is that they act mainly to increase house prices.

The recommended set of subsidies described above, however, is mostly about better targeting of existing subsidies – in particular the mortgage interest deduction and GSE cross-subsidies – so that there should be no net increase in housing demand because of the re-targeting, and which might even relieve a little of the pressure on house prices. However, there is no disguising that a Biden campaign-inspired DPA program would be a significant new subsidy to homeownership. Given the pandemic's increase in demand for housing, even the strong targeting of the DPA program is likely to translate

[57] See FHA, "Annual Report to Congress Regarding the Status of the FHA Mutual Mortgage Insurance Fund 2020," https://www.hud.gov/sites/dfiles/Housing/documents/2020FHAAnnualReportMMIFund.pdf, 8-12.

primarily into making today's homeowners richer rather than translating mainly into increasing homeownership.

Therefore, if policymakers don't solve the construction shortfall problem, any subsidies to increase homeownership will likely be for naught, making things even worse by putting house prices further out of reach of even more FTHBs.

The Shortfall: How Much and Why?

In 2018, the New Democrat Coalition, a caucus of business-friendly Democrats in the House of Representatives, produced a report entitled "Missing Millions of Homes."[58] In my view, this report was the first substantive and non-politicized policy publication pointing out how, following 2008, there had not been the traditional cyclical return to building large numbers of housing units (meaning single-family and multifamily combined).[59] As shown below in Chart 1, new units built between 2008 and 2020 have never gotten past 1.3 million annually, an amount well under pre-2008 levels (construction averaged over 1.5 million units per year in the forty years from 1968 to 2007, with several peaks over 1.8 million) and also under the 1.6 million units per year I estimate are the minimum needed today to keep up with current population growth and household formation. (Current forecasts are for construction in 2021 to finally reach, for the first time in over a decade, approximately 1.6 million units – under, I should note, the extraordinary pressure of house prices increasing with unprecedented rapidity during the pandemic.) Analysts estimate that there is now a cumulative shortfall of millions of homes, with such estimates varying widely; two recent reports cite shortfalls of 3.8 and 5.5 million units.[60]

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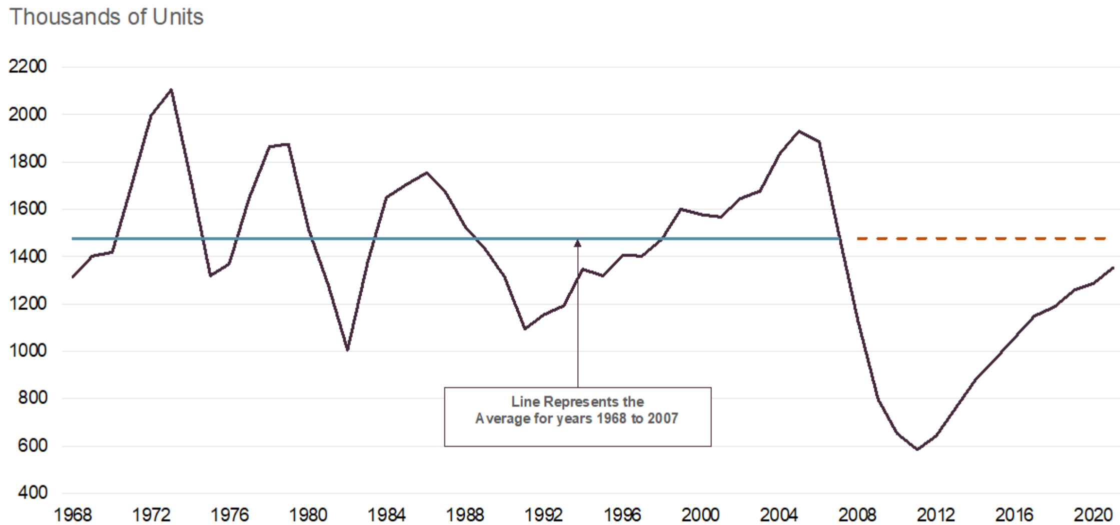
[58] See "Missing Millions of Homes: Preliminary Findings of the New Democrat Coalition Housing Task Force," June 2018, https://newdemocratcoalition.house.gov/imo/media/doc/NDC%20Missing%20Millions%20of%20Homes_Housing%20TF%20Findings%20Report_June%202018.pdf.

[59] There have been a series of go-nowhere presidential activities related to burdensome zoning that raised the cost of homes. As zoning is a state and local activity, these efforts fell more into the "bully pulpit" style of trying to influence outcomes, but as far as I can tell, little came of it all. Democratic efforts focused on "exclusionary" zoning, while Republican efforts focused more on regulations of all types (including environmental regulations) – reflecting their different worldviews and politics. See Michael Stegman, "Eliminating Exclusionary Land Use Regulations Should Be the Civil Rights Issue of Our Time," Harvard Joint Center for Housing Studies, August 2019, https://www.jchs.harvard.edu/research-areas/working-papers/eliminating-exclusionary-land-use-regulations-should-be-civil-rights. The introduction recounts some of this background and speaks to the issue, albeit from a Democratic perspective.

[60] See Kenneth T. Rosen, David Bank, Max Hall, Scott Reed, and Carson Goldman, "Housing is Critical Infrastructure," Rosen Consulting Group, June 2021, https://cdn.nar.realtor/sites/default/files/documents/Housing-is-Critical-Infrastructure-Social-and-Economic-Benefits-of-Building-More-Housing-6-15-2021.pdf, and Rebecca Klapper, "Freddie Mac Analysis Says US Needs 3.8M More Homes to Meet Housing Demand," *Newsweek*, September 1, 2021,

Chart 1: New Privately-Owned Housing Units Completed*



* This includes both single-family and multifamily units; the data for only single-family units shows a generally similar pattern. The dotted line represents a continuation of the 1968-to-2007 average to visually indicate the shortfall from 2008 to 2020.

The impact of this post-financial crisis shortfall, of course, shows up in how the prices of homes have been increasing faster than income. Specifically, in the ten years ending 2019 Q4 (that is, till right before the pandemic hit), house prices went up at a rate of 3.80 percent annually compounded, whereas by comparison the median wage went up by only 2.74 percent.[61] This disparity was making housing a little bit more unaffordable to the typical family year after year. (Over those ten years, the house price increase cumulatively was 45.2 percent versus just a 31.0 percent increase in median wages. – a meaningful 14 percentage point spread adversely impacting affordability. The long-term decline of interest rates during this period offset to a degree the monthly carrying costs for a house, but not of

https://www.newsweek.com/freddie-mac-analysis-says-us-needs-38m-more-homes-meet-housing-demand-1625034. The former report was sponsored by the National Association of Realtors, an industry advocacy group, so it may very well be biased; it estimates the shortfall at 5.5 million units. My personal estimate is towards the lower end of the range, more like 4-4.5 million units.

[61] Median rather than average income figures are appropriate for issues revolving around what first-time homebuying families can afford. House price data are from the Freddie Mac House Price Index (quarterly purchase-only index, US summary), https://www.fhfa.gov/DataTools/Downloads/Pages/House-Price-Index-Datasets.aspx#qpo; median wage data are from the Social Security Administration database, https://www.ssa.gov/oact/cola/central.html.

course the front-end amount needed for a downpayment.) The pandemic then supercharged house price increases, which have moved up in the 20 months since it began by over 26 percent. While the housing finance policy community and the media did not react strongly to the findings of the New Democrat Coalition report when it came out in 2018 or even the next year, the extreme home price increases during the pandemic absolutely got their attention and the issue became, in 2021, very much a front-burner topic in Washington.[62]

The Coalition report – which was refreshingly (and unusually) non-partisan – listed four major causes of the construction shortfall. These are, with my comments on each:

(1) *"Zoning and land use regulations are slowing and restricting building of housing*." The politics behind such regulations are broadly referred to as NIMBY ('not in my backyard'). It is a very powerful political force, as the local politics of such barriers to new construction are highly favorable for restrictions – after all, those restrictions raise property values for the majority of the local voters who already own homes in a particular community, while those who lose out by not being able to afford new homes often aren't even voters in that local community.

(2) *"Demand has shifted to walkable, transit-served urban areas, which are in short supply."* It was indeed much easier to quickly and cheaply build housing (especially starter homes) when that meant mostly developing dozens or even hundreds of acres at a time in the further-out suburbs, which was the main pattern of development for decades. By comparison, getting approval to build units, and then doing so, at some scale in dense urban areas is quite slow and expensive, and even iffy as to whether approvals will ever be obtained.[63] The recent strong trend towards urban living, however, may have been upended by the pandemic, so there is possibility of a turnaround on this issue.

(3) *"Construction funding is less available in the aftermath of the financial crisis."* Construction lending has long been considered one of the riskiest types done by banks, and it was a source of large losses in the financial crisis. As a result, banking regulators have made it much more burdensome to do, reflecting that history of riskiness. These policies presumably impact the many small- and medium-sized local builders who have long been the backbone of single-family construction.

[62] There is an old saying in Washington that the political system only pays attention to an issue when it gets to be a crisis. In the case of the housing shortfall, that would seem to be the case.

[63] In recent years, there is strong political resistance to anything considered "gentrification" in many key urban areas. This is one of the reasons why approvals to build are sometimes never obtained.

(4) *"Construction labor is not getting more productive and the labor pool is not increasing."* After the financial crisis, housing construction plummeted to levels under (sometimes far under) 1 million units per year for a long seven years beginning in 2009. This was well beyond what has historically been the pattern in an industry that was already strongly cyclical. Thus, there was a resulting large and permanent loss of skilled labor (e.g., carpenters, plumbers, electricians), which will take considerable time to reverse. In addition, immigration restrictions are cited as a source of labor shortages. In the pandemic, physical goods can be added to the shortage list, with the scarcity of lumber and appliances having been well publicized.

Again, I view this report, with its four key causes, as being refreshingly non-partisan, and nuanced in that it lists multiple causes behind the shortfall, which seems right to me. (In my experience, big problems usually have multiple causes.) Since the construction shortfall became a front-burner issue in the last year or so, the articles I have seen on the topic have mostly been fairly politicized, with progressives tending to blame solely "exclusionary zoning" and conservatives tending to blame solely the "heavy hand of government regulation."[64]

What to Do About It

These factors, from NIMBY in all its varieties to material and labor shortages to financing difficulties, need to be attacked aggressively to overcome them and unleash housing construction to produce not just the approximately 1.6 million units needed each year to meet new household formation demand, but significantly more units to help clear the backlog of unmet demand. Realistically, then, I estimate around 2 million units per year are needed for most of a decade to make up for that backlog. Without such an aggressive effort, any attempt to push the homeownership rate past the 65 percent barrier would be virtually doomed, with new initiatives and subsidies translating mostly into house price increases rather than into a higher rate of homeownership.

Interestingly, the challenge of addressing the construction shortfall does not fit well with the usual expertise and focus and powers found in Washington. Working from the list of causes found in the New Democrat study from 2018:

[64] In particular, conservatives point fingers at California, which as the largest state with maybe the worst shortage significantly impacts the national averages, and its heavy state environmental regulations that are considered simply anti-development (i.e., against development of all types, not just residential housing).

Zoning and land use regulations. These are local and state-level issues, far from the usual purview of federal officials, who have no direct involvement in or authority over them. (Current thinking is for the federal government to give local communities awards if they loosen up on zoning.)

Demand shifting to walkable, transit-served urban areas. This shift is not a "problem" to be solved in the classic policy-development sense, but rather consumer preference. And from an energy efficiency perspective, it is a good thing. So, at first blush, it will just have to be accommodated, making the challenge even harder.

Construction funding is less available. This is the sole issue that classically fits Washington's focus and expertise, as the two main relevant federal regulatory agencies are the Office of the Comptroller of the Currency (which regulates national banks) and the FDIC (which regulates many small banks). The White House and Congress are in an excellent position to attack this issue directly.

Construction labor challenges. The shortage of skilled construction labor goes back years before the pandemic. This is not an issue that the federal government has any significant track record of successfully addressing, as things such as apprenticeship and training programs have been discussed for years – with little to show for it. This labor shortage has now been joined by a materials supply shortage among all the other supply-chain shortages at this time in the pandemic – another area where progress has not yet been obvious.[65]

Given how prominent the construction shortfall issue has become in the past year of the pandemic, the Biden administration is gearing up to address it – although, as described above, this is going to require developing expertise and policies for the first time in several key fields, including those beyond federal authority, and so it is not realistic to expect quick success.

Nevertheless, there is little choice but to try – and the Biden administration has begun to do so, with Marcia Fudge, secretary of HUD, leading the way so far with several announcements. In my view, it would be best if the administration pursued this effort as a bipartisan activity, as that would have more chance of long-term success in all 50 states. Also, given how important it is to the economy and the well-being of millions of families, I view it to be about as big and deep an effort as any other issue for the White House. I would recommend, in fact, that it be elevated in profile, using one of two classic Washington approaches to prioritize important issues: (1) appoint a prominent White House "czar" to

[65] Immigration often is spoken of as a related issue, in that the federal government could (it is claimed) help construction by certain immigration reforms. This topic is beyond the scope of this paper.

coordinate activities throughout the federal government to address all the key barriers to construction returning to the needed level, or (2) appoint a bipartisan Presidential Commission chaired by two prominent individuals.[66] In the meantime, ideas are coming out of the administration that are, presumably, just a start as more homework is done on the topic.[67]

In Addition, the Starter Home Challenge

While the focus of this section is on homes without regard to price point, it is well observed that the shortage is most acute in "starter homes" – low price-point homes that the typical FTHB would be looking at. I agree with that observation. The administration and housing advocates refer to the challenge as concerning "affordable housing."

The causes of this shortage of starter homes are several. For example, starter homes were often built on the fringes of metropolitan areas where the cost of the land was very low; however, with the consumer preference for urban living, such construction is less impactful than before. As another example, many local governments have in recent years significantly increased the fixed cost per house that a developer has to pay in fees (with California being cited as an extreme case with the fees going up past $150,000 per unit), which leaves developers no choice but to aim for higher price-point homes.[68]

This is another problem for which solutions will not be easy. So-called building innovations such as manufactured housing, shipping-container-based homes, and even 3D printed housing might play a role, but none of these address land cost, which will require denser housing and not just cheaper ways to build single-family structures. So, in California, for example, one focus has been on "accessory dwelling units" where single-family owners can add what is sometimes called a "mother-in-law" apartment to their house; another focus is on allowing up to four units on a lot traditionally zoned for single-family housing. It is of course unclear at this time to what extent such alternatives, even if now allowed, will be taken up by the owners of single-family home properties and over what timeframe. This challenge of land cost should be at the core of the administration's high-profile effort to address the construction shortfall.

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[66] A model for this would be the Simpson-Bowles Commission, appointed under President Obama, to focus on the budget deficit and in general fiscal responsibility. Unfortunately, that commission was a failure as, in my view, not enough members could put their partisanship aside to support compromise policies.
[67] It is beyond the scope of this paper to report on those evolving ideas.
[68] See Terner Center for Housing Innovation, "Residential Impact Fees in California," University of California-Berkeley, August 2019, https://ternercenter.berkeley.edu/blog/residential-impact-fees/.

The Impact on Racial Homeownership Gaps

There is a large volume of policy papers today that delve into the highly complex topic of why the racial homeownership gaps are what they are and what would be necessary to significantly reduce and eventually end them. Instead, the purpose of this section is demonstrate why reducing racial homeownership gaps is key – i.e., the most impactful leverage point – to increasing the average national homeownership rate, and what generally the impact of the policies recommended above would be on those gaps.

Some Basic Numbers

Chart 2: Homeownership Rate and Median Household Income, 1994 and 2019[69]

	Homeownership Rate				Median Household Income			
	1994 Q4	% of W*	2019 Q4	% of W	1994	% of W	2019	% of W
White	70.2%		73.7%		$60.1 K		$76.1 K	
Hispanic	42.0%	60%	48.1%	65%	$40.1 K	67%	$56.1 K	74%
Black	42.6%	61%	44.0%	60%	$36.0 K	60%	$46.1 K	61%
Asian	47.6%	68%	55.7%	76%	$69.3 K	115%	$97.2 K	128%

* "% of W" means percentage as compared to the equivalent non-Hispanic white figure.

Chart 2 dimensions the basics of the racial homeownership rate gaps today (while most calculate the gap in percentage point terms, I prefer it to be in terms of the ratio of the homeownership rates, as shown above). I show the ratios also for 1994, twenty-five years earlier, in order to get a notion of a longer-term trend.[70] The basic conclusions are:

- *Gap size.* The highest racial homeownership rate ratio is for Asian families at 76 percent (yielding the lowest ratio gap of 24 percentage points), second for Hispanic families at 65 percent (a 35-percentage point ratio gap), and lowest for Black families at 60 percent (a 40-percentage point ratio gap).

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[69] I have defined the categories as I most often see them: white (meaning non-Hispanic white), Hispanic (even though it is an ethnicity and not a race, and includes various races), Black, and Asian. Homeownership rate by race is from the Federal Reserve of St. Louis FRED database. Homeownership Rate by Race and Ethnicity for "Black Alone" (https://fred.stlouisfed.org/series/BOAAAHORUSQ156N), "Hispanic (of Any Race)" (https://fred.stlouisfed.org/series/HOLHORUSQ156N) and "All Other Races" (https://fred.stlouisfed.org/series/AORHORUSQ156N). Median Household Income by race from the Census Bureau via Statista, https://www.statista.com/statistics/1086359/median-household-income-race-us/.

[70] Because of the housing and mortgage bubble that burst in 2008, in the entire period from about 2001 (when the bubble showed the first signs of beginning) to past 2016 (when the homeownership rate bottomed out), there is quite a lot of distortion in the figures. That is why I chose 1994 (the earliest year some data is available) as the base year – so that both the beginning and ending years were relatively "normal" – to show a reasonably non-distorted trend.

- *Gap trend.* The gap for Asian families has noticeably decreased over time, as their ratio went from 68 percent in 1994 to 76 percent in 2019; for Hispanic families, the gap has decreased modestly, as their ratio went from 60 to 65 percent; for Black families, the gap has remained virtually unchanged, with the ratio actually declining from 61 to 60 percent.
- *Relation to median household income.* The two key economic variables that capture the ability to purchase a home, in my view, would be median household income and some similar measure of household savings or wealth. The former is readily available and, as shown above, indicates some significant correlation with the level of and change in the racial homeownership rate ratios. In particular, note how the increasing homeownership rate ratios for Asian families (up by 8 percentage points) and Hispanic families (up by 5 percentage points) very roughly parallel the trend in the household median income ratios (up by 13 percentage points for Asians and 7 percentage points for Hispanics).[71] By contrast, the stagnation of the Black family homeownership rate ratio is matched almost exactly by the same stagnation of the median household income ratio, both hovering tightly around 60 percent – leaving a 40 percentage point ratio gap. That 40 percent ratio gap is very large, and is not going to be strongly offset by small-bore or technical housing finance changes.

The measures above of racial homeownership and income figures naturally represent, by definition, averages – not all Black families have low incomes, not all Asian families have high incomes, and so on. To gain some extra insight into why the gaps are what they are, see Chart 3 below.

[71] I would expect measures of household savings to show a similar pattern.

Chart 3: Homeownership Rate vs. Race and Other Factors[72]

	Pop. % - 2019	H-O Rate 2019	Median Age		% Foreign-Born	Geographic Concentration
White	60.1%	73.7%	44		4%	NM*
Hispanic	18.5%	48.1%	29		40%	Medium
Black	13.4%	44.0%	34		8%	NM*
Asian	5.9%	57.6%	37		64%	High

*NM – not meaningful

Three observations from Chart 3 are worthy of note:

- *Age.* The Hispanic median age at 29 is extremely low, and this impacts the homeownership rate in that younger household heads are less likely to own a home, everything else being equal (for all households, one with a head under 35 years old had a 2019 homeownership rate of just 37.6 percent, while those over 65 had an extremely high 79.0 percent rate). The impact is more modest for Asian and Black families.
- *Percent foreign-born.* The US has been in the midst of a wave of immigration that is high by historic standards. This shows in the very high percent of Asians who are foreign-born and the high Hispanic figure as well. Everything else being equal, a high percentage of foreign-born people will be correlated with a somewhat lower homeownership rate, as new immigrants almost always enter the country not owning a home and it can take a considerable amount of time for reasonable equilibration to occur.
- *Geographic concentration.* The Census Bureau reports a surprisingly large regional difference in the homeownership rate, with the Midwest being the highest at 69.5 percent and the West the lowest at 60.3 percent. This is probably explained mostly by how much house prices – relative to regional wage levels – have risen at different rates in the various regions, driving an inability to afford ownership. In addition, the percentage of the population who are foreign-born also varies significantly by region. (In fact, California, the most populous state, with its extremely high

[72] Sources: Homeownership Rate 2019 Q4 from Census Bureau https://www.census.gov/housing/hvs/files/currenthvspress.pdf; Population Percentage for 2019 from the Census Bureau, https://www.census.gov/quickfacts/fact/table/US/PST045219; Median Age for 2019 from National Equity Atlas, https://nationalequityatlas.org/indicators/Median_age#/; Median Household Income for 2019 from Statista, https://www.statista.com/statistics/233324/median-household-income-in-the-united-states-by-race-or-ethnic-group/; Percent Foreign-Born from US Census Bureau 2007 American Community Survey Table 1, https://www2.census.gov/library/publications/2010/acs/acs-11.pdf. (While outdated, these figures should still be directionally accurate.) Again, in reviewing Chart 3, it is important to remember that all these figures are based upon averages – not every Hispanic family breadwinner is young, not every Asian family resides in a low-homeownership-rate state, not every Black family is low-income. Policy development focused on groups must ultimately be effective for the individual family and its characteristics as well.

house prices and also high immigrant percentage of its population, has the second lowest homeownership rate among the 50 states at a very low 54.8 percent.) This is important in that Asian families heavily reside in California and the low-homeownership-rate New York City metropolitan area. Hispanic families have a more modest concentration, in particular in the West and Southwest, which will similarly push the rate down to a modest degree.

Thus, at least at this time, it is unclear exactly what should be the target homeownership rates by each racial or ethnic group as any such target should take into account the differences in age, percentage born abroad and geographic location. While such differences absolutely do not explain away most of today's racial homeownership gaps, they do indicate some sophisticated analysis is needed to define in a rigorous manner what is quantitatively meant by "eliminating the gaps."

A Simple Thought Experiment

Based upon the information in Chart 2, it is clear that it will be very difficult to further increase the white homeownership rate, which is already 73.7 percent. By examining the rate for other countries, in particular those of common legal and social heritage (e.g., Canada, UK, Australia), I estimate a target of 77 or 78 percent to be as high as can reasonably be expected. Applied to the 60 percent of the population that is non-Hispanic white, that means the overall homeownership rate would increase by only about 2.5 percentage points – not that much.

Instead, there is just so much more room for improvement in the other categories. In science, there is the notion of a "thought experiment." In that vein, consider if those homeownership rates were to close just half the ratio gaps versus the non-Hispanic white one. The result would increase the average national homeownership rate by almost 5 percent. This increase would provide a strong base to a major breakout from the 65 percent national rate that the country has been stuck in for more than half a century.

What the Impact Would Be

As a broad generalization, the various programs suggested above to support a higher homeownership rate, centered around (1) taking already-large existing interest rate subsidies (including cross-subsidies) and targeting them far better, in particular at FTHBs from low-income/low-wealth backgrounds, and (2) enacting a major new and generous (and hopefully effective) downpayment assistance program also to be highly targeted at such FTHBs, will clearly disproportionately help Black and Hispanic families. That's because they, on average, have lower incomes (as shown in Chart 2) and lower family wealth, and so

would be more likely to be in the targeted categories. (Hopefully, efforts by the current HUD secretary to eliminate current discrimination in housing and mortgage markets will be successful as well, benefitting those very same targeted categories of potential homeowners.)

As a result, the recommendations above should have, over time, a significant impact on reducing racial homeownership gaps. While this would take considerable time to occur (homeownership rates historically do not change quickly), I believe the policies and subsidies proposed above would accelerate the closure in a major way. For full elimination of those gaps – not the half utilized for the thought experiment, but adjusted for things like average age – policymakers will have to focus on raising the median household incomes and wealth of Black and Hispanic families. The gap in those fundamentals of family finances is just so large that it is not reasonable to believe that housing-specific policies alone are going to be able to offset them – instead, they will have to be approached separately, focusing on everything from the quality of neighborhood schools, to the high level of single-parent households, to the effectiveness of job training programs, and so on, along with of course attacking remaining current discrimination. That is a topic well beyond the scope of this paper.

Conclusion

The purpose of this paper, as per its title, is to show the policies that can raise the homeownership rate past the 65 percent barrier (after, of course, first helping to keep it from dropping in today's pandemic-distorted times). Part 1 demonstrated conclusively that such an increase – significant in size, sustainable for the long-term – is a very hard thing to achieve; after all, today's homeownership rate of around 65 percent is the same as it was five decades ago, despite many programs to increase it. For success, it is clear that very large dollar firepower will be needed to move the rate up as desired, which is what I have described in this Part 2.

Specifically, I recommend massively revising the two large interest rate subsidies to prioritize FTHBs of low-income/low-wealth background; one of these subsidies is the 600-pound gorilla mortgage interest tax deduction, which can have a large impact on the interest rate paid on starter home mortgages. I also recommend a generous, Biden-campaign-inspired DPA program, which can provide for the targeted families a large share of the downpayment (hopefully leaving them with a minimum of 5 percent equity upon closing). Together, these recommendations form a comprehensive program to subsidize the targeted FTHBs, but in a way that does not, net, unduly exacerbate house price increases. How much this can all reduce the downpayment and the monthly interest cost of a typical beneficiary naturally depends how tightly targeted the programs are and the exact terms of each. I very roughly

estimate that the downpayment might be reduced by up to half for a beneficiary (although, as the program is on-budget, it is unclear if enough funding would be made available for all the eligible families). In terms of the monthly interest rate reduction, the two subsidies together (i.e., the graduated income tax credit for interest expense and the GSE cross-subsidies) could reduce it by one-quarter. These are considerable amounts.

Unfortunately, the recent increase in house prices is already almost out of control, stemming from the pandemic interacting with the housing construction shortfall that has been going on for most of the last decade. I therefore recommend the most aggressive attack possible, and on a bipartisan basis, to address the full range of challenges holding back increased production volumes.

I fully recognize that the barriers to success in raising the homeownership rate are large, and at best it will take a long, sustained effort to have even partial success. But, after fifty-plus years of homeownership rate stagnation, we seem to have little choice but to try something new in order to maintain and improve the socioeconomic benefits that a higher homeownership rate can deliver to more of America’s families.