

# A Government Failure, Not a Market Failure

The financial collapse has its roots in a series of government actions that have distorted and obscured the true nature of home ownership.

By John H. Makin

*As a people we need, at all times, the encouragement of home ownership.*

HERBERT HOOVER, 1932

**T**HE IDEA that home ownership confers special benefits on American society is deeply embedded in our culture—so much so that our national tax policy confers a special benefit of its own on it. Home ownership is granted an advantage over all other forms of ownership in the form of an enormous deduction on the interest payments most individuals incur in financing their homes. Nothing else in

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the tax code comes anywhere near that deduction in scope or size. We have decided, as a nation, that home ownership is not only a good thing for an individual or a family, but that it is beneficial for the public at large and the country as a whole. Otherwise, why would it be necessary for the government to give it this kind of preferential treatment? Without it, clearly, we believe that the national rate of home ownership would be lower, and that a lower rate of home ownership would be deleterious to our common weal.

After 2000, the national push toward home ownership intensified in three dimensions, leading to a doubling of housing prices in just five years' time. First, the Federal Reserve Board's interest-rate policy drove down the cost of borrowing money to unprecedented lows. Second, a common conviction arose that home ownership should be available even to those who, under prevailing conditions, could not afford it. Finally, private agencies charged with determining the risk

and value of securities were exceptionally generous in their assessment of the financial products known as “derivatives” whose collateral resided in the value of thousands of mortgages bundled together. The ratings agencies understated the risks from these bundled mortgages by assuming that home prices were simply going to rise forever.

When the housing bubble burst in 2006, the damage to the financial system pushed the global economy into the worst contraction since the Great Depression. In the midst of the pain and suffering that have accompanied financial collapse and economic contraction—over \$15 trillion in wealth has been lost by American households alone while, to date, more than 6 million job losses have boosted the unemployment rate to 9.4 percent at this writing—much of the blame has been placed on unregulated financial markets whose behavior is said to have revealed a terrible flaw in the foundation of capitalism itself.

This was a market failure, we are told, and the promise of capitalism has always been that the self-correcting mechanisms built into the system would preclude the possibility of a systemic market failure.

But the housing bubble only burst after government subsidies pushed house prices up so fast that marginal buyers could no longer afford to chase prices even higher. A bubble created by rigged financial markets and a government-sponsored obsession with home ownership is not a result of market failure, but rather, a result of bad public policy. The belief that home ownership, per se, is such a benefit that no amount of government support could be too great and no pace at which home prices rise could be too fast is the root of the crisis.

There was no market failure.

**A**CCORDING to *The New Palgrave Dictionary of Economics*, an invaluable collection of precise summaries of virtually every topic in the dismal science: “The best way to understand market failure is first to understand market success, the ability of a collection of idealized competitive markets to achieve an equilibrium allocation of resources which is Pareto optimal.” Allow me to translate. “Pareto optimality,” a term named after the Italian economist Vilfredo Pareto (1848–923), is defined as an allocation of economic resources that produces the greatest good. Thus, if one changes the allocation of resources away from “Pareto optimality” for the purpose of making someone better off, that change will make someone else worse off. Economists have expended a great deal of effort to demonstrate that free and competitive markets produce an outcome that is “Pareto optimal.”

This is not to say that there is no such thing as market failure. There are many instances of market failure. Someone may possess information that others do not, as in insider trading, and thereby gain an illegitimate leg up. There may be too few players in a given market, which allows them to manipulate, hoard, and toy with prices. Capricious government intervention in cases where it is neither required nor appropriate constitutes another condition that may create a market failure.

There are also cases of market failure in which some people get a free ride while others bear a disproportionate burden. This is the case in national defense, for example, in which soldiers bear a burden non-soldiers do not. Consequently, a government subsidy for national defense is necessary for the maintenance of security and power, and the overwhelming majority of citizens acknowledges it and does not complain about it. National defense is a public good, perhaps the original public good.

Owner-occupied housing is something else that has been deemed a public good. Herbert Hoover’s affirmation of the need for encouragement of home ownership “at all times” came in 1932 at the fiercest stage of the Great Depression. Others have made powerful arguments that homeowners make better citizens and contribute to stable communities. Why renters do not and cannot offer the same contribution to the public good is never specified, but existing homeowners, homebuilders, mortgage lenders, and mortgage servicers have all seized on the idea that subsidizing home ownership is “Pareto optimal.”

It isn’t.

Subsidies for home ownership—in the form of full deductibility of mortgage interest, lower mortgage borrowing rates derived from government guarantees for mortgage lenders like Fannie Mae and Freddie Mac, and deductibility of local real-estate taxes—have long benefited those who own homes at the expense of those who do not. The size and severity of the burst bubble makes a mockery of the argument that the disproportionate gains to gains to homeowners also improved the welfare of renters. By erasing, in just a few years, nearly one-third of the wealth on the national balance sheet, the collapse has created a substantial loss in national welfare, including for renters.

Home ownership should not be considered a public good deserving of government subsidies even without the bubble collapse for a simple reason: Those who receive the subsidy get to capture the benefits in the form of home prices that are higher than they would otherwise be without government support. The subsidies make homeowners better off while they

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make renters worse off. They are, therefore, not Pareto optimal.

In addition, home-ownership subsidies are inherently unjust. They favor the relatively well-off at the expense of those who are poorer. Why? Because the value of an owned home and the size of the government subsidy both grow as income increases. A tax deduction tied to home ownership for a well-to-do American with a \$1 million mortgage and a \$60,000 annual interest payment is worth \$22,000 (assuming the American is in the 35 percent tax bracket). The higher the marginal tax rate rises, the more valuable the mortgage-interest deduction is to the homeowner. For a family with a modest income that may pay little or no income tax, the mortgage-interest deduction is worth virtually nothing. And yet, for the past 15 years, even the party in the United States most associated with preferential treatment for the poor began preaching the evangel of home ownership as a form of class salvation.

During Bill Clinton's first term, government housing policy changed substantially. After decades in which liberal politicians and thinkers devoted themselves to arguments for expanding the number of public-housing units, the disastrous condition of those units led the President, a "new Democrat," to a dramatic ideological shift in emphasis. No longer would public housing be at the top of the liberal Democratic agenda. Instead, borrowing from conservative ideas about the inestimable benefit of home ownership to the striving poor, the Clinton administration and members of his party in the House and Senate decided to use government power to achieve that aim.

In 1994, the "National Homeownership Strategy" of the Clinton administration advanced "financing strategies fueled by creativity to help homeowners who lacked the cash to buy a home or the income to make the down payments" to buy a home nonetheless. It became U.S. government policy to intervene in the marketplace by lowering the standards necessary to qualify for mortgages so that Americans with lower incomes could participate in the leveraged purchases of homes.

The goal of expanding home ownership led to the creation of new mortgage subsidies across the board. The loosening of standards became the policy of Fannie Mae and Freddie Mac, the pseudo-private "government-sponsored enterprises" that bought mortgages from originating lenders. A particular change in the tax law in 1997 encouraged many households to make buying and improving a home the primary vehicle by which they enhanced net worth. By eliminating any capital-gains tax on the first \$500,000 of profits from the sale of an owner-occupied residence once every two years, Washington encouraged enterprising American families to purchase homes, fix them up, re-sell them, and then repeat the process. Flipping became a financial pastime for millions because this special advantage created a new incentive—which didn't exactly fit the model of encouraging people to remain in a stable home for many years and thereby help to stabilize the neighborhood around them.

There was, however, a rival to home ownership as a way of building wealth in the late 1990s—the run-up in the stock market, which was caused by another bubble, this one in the technology sector. Given the size of the gains in the stock market, which were running 20 percent or more a year, the relative desirability of home ownership eroded. But when, in 2000, the tech bubble burst, households were left in search of an alternative way to store and enhance wealth. Home ownership emerged as the most promising alternative. After 2000, and especially after 2002, U.S. real house prices began to surge.

**E**VERYTHING I have described thus far constituted a necessary but not sufficient precondition for a full-fledged housing bubble. It took the addition of a new market in derivatives to drive bankers, lenders, and credit agencies to create the conditions for an implosion by expanding mortgage financing to borrowers who could not possibly afford the homes they were purchasing.

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no longer be an impediment to home ownership for any American.\* Was it any wonder that a home-buying frenzy occurred when Countrywide's chieftan was suggesting that there was no need for a purchaser to supply even a minimal equity stake in his purchase? During 2004 and 2005, the rise in home prices accelerated. That, in turn, caused Americans to refinance their homes to remove their equity—their accumulated wealth, in other words—and convert it into disposable income. They did so because they were confident the equity would simply be recreated by continued growth in the value of their homes.

The hunger for more mortgages that could serve as backing for more new securities led to the acceleration of undocumented, no-down-payment, negative-amortization mortgage loans to individuals with virtually no prospect of servicing them. The designers of derivative securities effectively collaborated with the rating agencies, such as Standard & Poor's and Moody's, that were relied upon (often through government mandate) by pension funds and other gigantic repositories of wealth with identifying the securities safe enough to invest in.

A situation in which creators of derivatives provide the monetary compensation for the very agencies that are tasked with determining the riskiness of their securities hardly constitutes a competitive market. Indeed, it constitutes dangerous collusive behavior. But that collusion, again, was made possible by the distorting actions of government agencies, which effectively provided a subsidy for risk-taking that was, by definition, unsustainable.

**I**T IS FAIR to ask, in the light of past bubbles that have burst—like the entire economy of Japan in the 1990s and the tech-stock tragicomedy—why investors were prepared to take on the substantial risks tied to unfamiliar derivative securities whose value was tied to the continued rise in house prices. A substantial part of the answer lies with the Federal Reserve Board.

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\*"Mozilo: End Down Payment Requirement," *National Mortgage News* (February 17, 2003).

It deliberately adopted a policy that it would not seek to identify bubbles and then to act in ways that would let the air out slowly. Instead, Fed Chairman Alan Greenspan allowed bubbles to inflate and then stepped in to repair any damage afterward. This constituted a substantial subsidy to excessive risk-taking.

The policy became clear in 1998, the year in which the unwinding of the Asian currency crisis together with Russia's defaulting on its debt created huge volatility in the credit markets. At the time, Long Term Capital Management, a hedge fund, was on the verge of collapse, and an aggressive intervention was staged to save it. The New York Fed provided its offices and encouragement to bring financial firms together to contain it.

The salvation of Long Term Capital Management suggested a new reality for the marketplace: Aggressive risk-taking in pursuit of huge profits was manageable even if bubbles were created, just so long as the Fed was around to raise the "systemic risk flag" in the event of serious trouble. There would always be a rescue; the trick was to get out before everything began to collapse. It was this fact that led Charles Prince, then the head of Citicorp, to give the game away in July 2007 about the reckless and imprudent nature of his bank's conduct. "When the music is playing," Prince said, "you've got to get up and dance."

The housing bubble was thus a fully rational response to a set of distortions in the free market—distortions created primarily by the public sector. The heads of large financial institutions, as Prince's remark suggested, recognized the risk-taking subsidy inherent in public policy, but felt they had no choice but to play along or fall behind the other institutions that were also responding rationally to the incentives created by government intervention.

The housing collapse and its painful aftermath, including that \$15 trillion wealth loss for U.S. households (so far) does not, therefore, represent a market failure. Rather, it represents the dangerous confluence of three policy errors: government policy aimed at providing access to home ownership for American households irrespective of their ability to afford it; the Fed's claim that it could not identify bubbles as they were in-

flating but could fix the problem afterward; and a policy of granting monopoly power to rating agencies like Standard & Poor's, Moody's, and Fitch's to determine the eligibility of derivative securities for what are supposed to be low-risk portfolios, such as pension funds.

**T**HE FED'S bubble policy has evolved in a constructive direction since the bursting of the U.S. housing bubble. The trauma of dealing with the aftermath, including the fire sale of the investment bank Bear Stearns and the outright failure of Lehman Brothers, has convinced the Fed that more effort should be directed toward identifying bubbles before they grow too large.

Now the collusive relationship between rating agencies and creators of derivative securities needs to be ended by bringing more market discipline to the process. Free entry into the rating business should be permitted. The monopoly of a small number of rating agencies to determine the eligibility of new securities for investment by massive pension funds is unjustifiable. The practice whereby the creators of such derivative securities compensate the rating agencies for the ratings also needs to be ended.

Alas, the federal government's response to the collapse of the housing bubble has been deeply prob-

lematic. It has chosen to provide additional subsidies to homeowners while nationalizing the government-sponsored enterprises, Fannie Mae and Freddie Mac, that helped to subsidize lower mortgage-interest rates. While the extreme distress visited on American households by the collapse of the housing bubble certainly needs some alleviation, over the longer run we must have a serious national debate on the question of the degree to which we still want to consider home ownership a public good.

The long-term solution is for government to stop playing favorites, as it has for decades with housing. Home ownership should neither be penalized nor favored under government policy. We have seen how that distortion led inexorably to a degree of wealth destruction we have not seen in our lifetimes. The distortion of the market introduced by government intervention can and must be brought to an end. The market that would take its place after this dramatic and admittedly difficult change would allow Americans to allocate their resources more effectively. It would no longer create an unjust advantage for the wealthy homebuyer. And it would, finally, make it possible for Americans to see their homes as they should be seen—not as investment vehicles, but rather, as the places they live, the hearthstones of their families. 🌱