

Housing Subsidies and Homeowners: What Role for Government-Sponsored Enterprises?

Dwight M. Jaffee
University of California
Berkeley
jaffee@haas.berkeley.edu

John M. Quigley
University of California
Berkeley
quigley@econ.berkeley.edu

Abstract

This paper analyzes the federal programs providing financial support for U.S. housing: direct appropriations programs (e.g., public housing and vouchers); tax expenditure programs (e.g., the low-income housing tax credit and the special tax treatment of owner-occupied housing); and credit guarantee programs (e.g., activities managed by the Federal Housing Administration, the Veterans' Administration and the Government Sponsored Enterprises, GSEs). We review and quantify the public resources devoted to these programs – congressional appropriations on housing programs, the costs to the federal treasury arising from the favorable tax treatment of housing, and the market value of federal credit insurance and credit guarantees. The review documents the small fraction of housing subsidies devoted to low-income households. It also establishes the quantitative importance of credit guarantees in the federal system of housing support.

We then consider the activities of the GSEs in more detail, focusing on their roles as mortgage assemblers, conduits, guarantors, and portfolio investors. We consider the rationale for these activities, the nature of the federal subsidy provided, and the likely consequences of changes in the federal role. We then analyze two current and competing proposals to limit direct GSE mortgage investments and to redirect GSE resources to “affordable” housing. We propose, instead, that a user fee be imposed on GSE debt (to compensate taxpayers for the value of the implicit guarantee on this debt), and that the proceeds be used to augment the current housing voucher program. This would increase the economic efficiency of the GSEs and would further the equity objectives articulated by the Congress.

January 2007

Previous versions of this paper were presented at the Brookings-Wharton Conference on Urban Affairs, Washington, DC, October 19-20, 2006; and the Annual Meetings of The North American Economic and Finance Association, Chicago, IL, January 4-7, 2007. We are grateful to Su Jeong Lee for research assistance.

I. Introduction

Housing subsidies in the U.S. are provided by a patchwork of different programs and serve a variety of constituencies. The best known programs are designed to serve low-income households by expanding the stock of “affordable” housing directly through new construction or indirectly by increasing the effective demand for housing. The most expensive housing subsidy programs provide tax relief diffusely to homeowners of all income classes. The least well understood programs provide government guarantees which reduce the cost of housing credit in the market. This paper considers these latter programs in the broader context of U.S. housing policy.

In section II below we provide a brief review and taxonomy of federal housing programs, including direct public expenditures on housing and indirect expenditures through the tax system. We also describe federal credit and guarantee programs which reduce the cost of credit to those purchasing housing. In section III, we summarize estimates of the economic and budgetary costs of these programs. We also compare these estimates across housing programs that serve households of various income classes. In section IV we consider reforms to credit and guarantee programs that would improve efficiency and reduce costs to the U.S. Treasury. Section V is a brief conclusion.

II. Federal Housing Programs

There are a variety of taxonomies for describing the role of the federal government in housing and the public resources devoted to these activities. Low-income housing programs may be distinguished from programs benefiting middle or upper income households. Programs based on direct congressional expenditures may be distinguished from those based upon tax expenditures, and programs which directly add

units to the housing supply may be distinguished from those whose effects upon the quality and quantity of housing are more indirect. There is no simple correspondence mapping these taxonomies back to program types. We proceed by describing programs briefly from a budgetary perspective.

A. Direct Federal Expenditures on Housing

1. Construction Programs

Direct federal expenditures on housing began with the Public Housing Act of 1937 which was intended to “remedy the acute shortage” of decent housing through a federally financed construction program which sought the “elimination of substandard and other inadequate housing.” For a quarter century, low rent public housing was the only federal program providing housing assistance to the poor. Dwellings built under the program are financed by the federal government, but are owned and operated by local housing authorities. Importantly, the rental terms for public housing specified by the federal government ensure occupancy by low-income households, currently at rents no greater than thirty percent of their incomes.

This program of government construction of dwellings reserved for occupancy by low-income households was supplemented by a variety of programs inviting the participation of limited dividend and nonprofit corporations in the 1960s. These latter programs, directly increasing the supply of privately-owned “affordable” housing, were suspended in the early 1970s. But housing capital is long-lived, and at the turn of the century there were still more than a half million of these subsidized units in the housing stock (Quigley, 2000, Table 1).

Section 8 of the Housing and Community Development Act of 1974 increased the participation of private for-profit entities in the provision of housing for the poor. The act provided for federal funds for the “new construction or substantial rehabilitation” of dwellings for occupancy by low-income households. The federal government entered into long-term contracts with private housing developers, guaranteeing a stream of payments of “fair market rents,” FMRs, for the dwellings. Low-income households paid twenty-five (now thirty) percent of their incomes on rent, and the difference between tenant payments and the contractual rate was made up by direct federal payments to the owners of the properties.

2. The Voucher Program

Crucial modifications to housing assistance policy were introduced in the Section 8 housing program: the restriction that subsidies be paid only to owners of *new* or *rehabilitated* dwellings was weakened and ultimately removed; and payments were permitted to landlords on behalf of a specific tenant (rather than by a long-term contract with a landlord). This tenant-based assistance program grew into the more flexible voucher program introduced in 1987. Households in possession of vouchers receive the difference between the “fair market rent” in a locality (e.g., the median rent, estimated regularly for each metropolitan area by the U.S. Department of Housing and Urban Development, HUD) and thirty percent of their incomes. Households in possession of a voucher may choose to pay more than the fair market rent for any particular dwelling, up to forty percent of their incomes, making up the difference themselves. They may also pocket the difference if they can rent a HUD-approved dwelling for less than the FMR.

In 1998, legislation made vouchers and certificates "portable," thereby increasing household choice and facilitating movement among regions in response to employment opportunities. Local authorities were also permitted to vary their payment standards from 90 to 110 percent of FMR. The 1998 legislation renamed the program the "Housing Choice Voucher Program;" it currently serves about 1.9 million low-income households.

B. Indirect Expenditures on Housing

1. Tax Expenditures.

i. Income Taxes

The most widely distributed and notoriously expensive subsidy to housing is administered by the U.S. Internal Revenue Service (IRS). Since the introduction of the federal income tax in 1913, investments in owner-occupied housing have been treated differently from other household investments. If taxpayers invest in a "standard" asset (such as equity shares), dividends accruing under the investment are taxed as ordinary income, and profits realized at the sale of the asset are taxed as capital gains. At the same time, the costs of acquiring or maintaining the investment become deductible expenses in computing the net tax liability under the IRS tax code.

In contrast, if a taxpayer makes an equivalent investment in owner-occupied housing, both the annual dividend (i.e., the value of housing services consumed in any year) and the first \$500,000 (for married taxpayers) of capital gains on qualified housing are exempt from taxation. Nevertheless, two important investment costs, mortgage interest payments (up to \$1 million for married taxpayers) and local property taxes, continue to be allowed as deductible expenses, although depreciation, maintenance, and repair expenses are not deductible.

Significant benefits of this form have been in effect since the enactment of the Internal Revenue Code. The budgetary cost of the program (i.e., the foregone income tax revenues resulting from these special provisions), detailed in the following section, are sensitive to monetary policy and tax policy. As interest rates increase, the value of the deduction for interest paid increases. If federal or local tax rates are reduced, the value of the homeowner deduction declines.

ii. Mortgage Revenue Bonds

States have always been permitted to issue debt, and the interest payments made by states (and their local governments) on this debt have been exempt from federal taxation. Until 1986, states were free to issue debt for virtually any purpose, including tax exempt bonds whose proceeds were used to build or buy residential housing. The Tax Reform Act of 1986 (TRA86) placed a cap on the volume of bonds which could be issued by states for “private purposes.” This cap was revised several times; in 2002 the cap for each state was set at the larger of \$225 million or \$75 per state resident. The cap is automatically adjusted annually for inflation. “Private purposes” include most tax exempt facilities (e.g., airports), industrial development agencies, student loans, and housing (multifamily construction and homeowner subsidies). The allocation of private purpose bond authority among these activities is undertaken by each state, and the priorities among states may vary substantially.

The subsidy provided by tax exempt bonds, the net difference between the market interest rate and the rate for tax exempt paper, varies with changes in federal tax rates and with interest rate policy. When interest rates are low and the spread between taxable and

tax exempt rates is small, tax exempt bonds may not be issued at all, since the costs of issue (underwriting, bond counsel, etc.) are relatively high.

iii. Low-Income Housing Tax Credits

The Low-Income Housing Tax Credit (LIHTC) Program was authorized by TRA86 to provide direct subsidies for the construction or acquisition of new or substantially rehabilitated rental housing for occupancy by lower income households. The LIHTC Program permits states to issue federal tax credits that can be used by property owners to offset taxes on other income, or which can be sold to outside investors to raise initial development funds for a project. For a property to qualify, owners must set aside twenty percent of units for households with incomes below fifty percent of the median income in the local area, or they may set aside forty percent of units for households with incomes below sixty percent of area median. Rents for these dwellings are limited to thirty percent of income. Qualification requires that these units be set aside for occupancy by lower income households for a period of thirty years.

The aggregate amount of tax credits authorized by the LIHTC program has been increased several times since its inception, to \$1.75 per person in 2002, with automatic adjustments for inflation annually since 2003. Federal tax credit authority is transmitted to each state, on a per capita basis, for its subsequent distribution to developers of qualified projects. The amount of the credit that can be allocated to a specific project is a function of its (non-land) development costs, the proportion of units set aside for lower income households, and its credit rate (four percent for projects also financed by the tax-exempt bonds described above and nine percent for other projects.) The credits are

provided annually for ten years, so a “dollar” of tax credit authority issued today has a present value of 6 to 8 dollars.

2. Federal Credit and Insurance Programs

i. Explicit Insurance Programs

The Federal Housing Administration (FHA) was established in 1934, at the depths of the depression, to oversee a program of home mortgage insurance against default. Insurance was funded by a fixed premium charged on unpaid mortgage loan balances. Subsequently this was changed to a fixed premium at closing and ultimately to a sliding scale based upon the initial loan-to-value ratio (a proxy for the riskiness of loans). The mortgage insurance fund overseen by the FHA was required to be “actuarially sound,” and for the most part it has remained so.

The Veterans’ Administration (VA) mortgage program was passed as a part of the GI bill in 1944 as a temporary “readjustment” program for returning veterans. It was transformed in 1950 into a liberal program of home loans available to veterans for a decade or more after returning to civilian life. In contrast to the mutual insurance concept of the FHA, the VA provided a federal guarantee for up to sixty percent of the face value of a mortgage loan made to a veteran, up to a legislated maximum. The difference between the actuarial risk of these VA mortgages and the fees paid by veterans represents the economic costs of the guarantee program to the federal government.

Over time, limitations in the legislated maximum loan size systematically reduced the fraction of new mortgages eligible for VA financing (and FHA financing, too),

reducing the share of VA and FHA guarantees in newly issued home mortgages, from 37 percent in 1950 to about 9 percent in 2004 (Quigley, 2006, Figure 3).¹

ii. Mortgage Credit

Federal support for housing credit also began in the aftermath of the great crash, with the establishment of the Federal Home Loan Bank (FHLB) System in 1932. FHLBs were chartered by Congress to provide short-term loans to retail mortgage institutions to help stabilize mortgage lending in local credit markets. Interest rates on these advances were determined by the low rates at which this government corporation, the FHLB Board, could borrow in the credit market. In 1938, the Federal National Mortgage Association (FNMA) was established as a government corporation to facilitate a secondary market for mortgages issued under the newly-established FHA mortgage program. The willingness of FNMA to buy these mortgages encouraged private lenders to make FHA, and later VA, loans.

In 1968, the Association was reconstituted as a Government Sponsored Enterprise (GSE), Fannie Mae; the change allowed Fannie Mae's financial activity to be excluded from the federal budget. Its portfolio of government-insured mortgages was transferred to the newly established Ginnie Mae, a wholly-owned government corporation. In contrast, ownership shares in Fannie Mae were sold and publicly traded. Fannie Mae continued the practice of issuing debt to buy and hold mortgages, but focused its operations on the purchase of conventional mortgages not guaranteed or insured by the federal government. Freddie Mac was established as a GSE in 1970, but it did not become a publicly traded firm until 1989. Originally, Freddie Mac chose not to hold purchased mortgages in its

¹ Of course, this is not the only reason for the decline in FHA and VA guaranteed mortgage finance. A large and competitive private mortgage insurance industry grew – and was facilitated by – these agencies.

portfolio. Instead, mortgages were pooled, and interests in those pools, mortgage-backed securities (MBS), were sold to investors with the default risk guaranteed by Freddie Mac.

The structure of mortgage credit has evolved, and today virtually all FHA and VA guaranteed mortgages are securitized by Ginnie Mae, whose guarantee is based upon the full faith and credit of the U.S. government. Other mortgages, subject to specific balance limits and underwriting guidelines—referred to as “conforming conventional” mortgages—are securitized by Freddie Mac and Fannie Mae. These MBS are guaranteed against default risk by the GSEs themselves. Still other mortgages, which do not conform to the balance limits or underwriting guidelines imposed by the GSEs, are routinely securitized by investment banks and other private entities. These “private label” MBS are typically issued as “structured” products in which the credit risk is allocated among different tranches of the security, allowing final investors to tailor their holdings to their risk preferences.

The two mortgage GSEs, Fannie Mae and Freddie Mac, operate under congressionally conferred charters, which provide both benefits and obligations. Their foremost benefit is an implicit U.S. government guarantee of their debt and MBS obligations, as described in detail in the next section. The GSE charters affirm their primary obligations to:

- “(1) provide stability in the secondary market for residential mortgages;
- (2) respond appropriately to the private capital market;
- (3) provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and

improving the distribution of investment capital available for residential mortgage financing;

(4) promote access to mortgage credit throughout the nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.”

In short, the GSEs are obliged to support the secondary market for residential mortgages, to assist mortgage funding for low- and moderate-income families, and to be attentive to the geographic distribution of mortgage funding, including underserved areas.

The GSEs carry out their mission through two distinct business lines: (i) they create and guarantee mortgage backed securities; and (ii) they purchase and hold whole mortgages and MBS in their on-balance-sheet retained-mortgage portfolios. The GSEs state that both business lines are required to meet their charter responsibilities to support the secondary mortgage market and to unify the geographic distribution of mortgage funding. Jaffee (2003) and Greenspan (2005), among others, have pointed out, however, that the unhedged interest-rate risk embedded in the retained-mortgage portfolios creates a large risk for the U.S. Treasury and a systemic risk for U.S. capital markets. These authors further argue that, since the GSEs issue MBS, the retained-mortgage portfolios are not at all necessary for the GSEs to carry out their charter obligations. This position underlies a current proposal (Senate Legislation S. 190) to limit the size of the GSE retained-mortgage portfolios. (See Congressional Record Service, 2005a, Wallison, 2005, and Jaffee, 2006). This proposal is discussed below.

The GSE responsibility for assisting low- and moderate-income families and underserved geographic regions was formalized in the Federal Housing Enterprise Safety

and Soundness Act of 1992, which requires the HUD Secretary to establish annual GSE Affordable Housing Goals (AHG). Table 1 reports the current housing goals for 2005 to 2008 as set in November 2004 (HUD, 2006). The goals represent the proportion of each GSE's annual mortgage purchases that must satisfy the conditions for each category. Housing units may count toward more than one goal, and the mortgages may be either for home purchase or for refinance. The 2004 rules also introduced, for the first time, subgoals that can be satisfied only by home purchase loans, shown in Part B of Table 1. Finally, as shown in Part C of Table 1, HUD also established a multifamily subgoal for the dollar volume of multifamily mortgage purchases.

The annual housing reports by the GSEs to HUD have systematically confirmed that the firms are meeting their AHG obligations.² A substantial literature has now developed analyzing the efficacy of the HUD housing goals for promoting home ownership among lower income families. The consensus conclusion is that the AHGs have achieved very little in terms of increasing homeownership among low-income families. This conclusion is based upon four very recent studies.

² However, in Fannie Mae's most recent report (Fannie Mae, 2006), the firm indicated it had missed its home purchase subgoals for low- and moderate-income buyers and for underserved areas. Freddie Mac (2006b) also indicates that HUD has questioned the data used in the firm's 2005 annual housing report. HUD can impose penalties and restrictions if it finds that either firm has failed to meet its goals.

Table 1. GSE Housing Goals, as set by HUD in November 2004

A. Primary Housing Goals	Goal Levels in 2005 - 2008				Goal Levels in
	2005	2006	2007	2008	2001-2004
Low- and Moderate-Income	52%	53%	55%	56%	50%
Special Affordable	22%	23%	25%	27%	20%
Underserved Areas	37%	38%	38%	39%	31%

B. Housing Subgoals for Home Purchase	2004 Regulation Home Purchase Subgoal Levels			
	2005	2006	2007	2008
Low- and Moderate-Income	45%	46%	47%	47%
Special Affordable	17%	17%	18%	18%
Underserved Areas	32%	33%	33%	34%

C. Special Affordable Multifamily Subgoal	New Subgoal Levels 2005-2008	Previous Subgoal Levels 2001-2004
Fannie Mae	\$5.49 billion	\$2.85 billion
Freddie Mac	\$3.92 billion	\$2.11 billion

Notes: Goals are stated in terms of the percentage of total mortgage purchases by each GSE that satisfies the stated value. A mortgage may count to more than one goal.

Summary Definitions (for full definitions, see HUD ,2004):

"Low- and moderate-income" is at or below 100% of area medium income (AMI).

"Special affordable" is at or below 60% of area AMI, or at or below 80% of areas AMI for low-income families in low-income areas.

"Underserved areas" refer to central cities, urban areas, and other areas with families living in low-income census tracts or in low- or middle-income tracts with high minority populations.

Bostic and Gabriel (2006) found no evidence of enhanced housing market performance (as measured by the homeownership rate, vacancy rate, and median house values) in census tracts for which activity in support of the GSE housing goals should be particularly effective. Their study is designed to control for the effects of the Community Reinvestment Act (CRA) of 1977, which provides incentives for commercial banks to lend in lower-income census tracts. The GSEs and banks both receive “credit” for mortgage lending in census tracts at or below eighty percent of the area medium income (AMI) threshold. Only the GSEs, however, receive credit for mortgage lending in census tracts above the eighty percent AMI threshold. This forms the basis of the Bostic-Gabriel test to determine if the AHGs have observable effects upon performance.

Gabriel and Rosenthal (2005) investigated the key factors associated with the exceptional growth in U.S. homeownership rates during the 1990s, disaggregated by metropolitan area, minority status, and income class. They found that household characteristics (income, age, and marital status) explain most of the increases in homeownership rates, and correlates of credit barriers explain only a very small share. Based on this evidence, they concluded that mortgage market interventions, such as those mandated by the AHGs, are unlikely to have large effects on homeownership.

Ambrose and Thibodeau (2004) analyzed directly the link between the GSE goals and the supply of mortgage credit (in contrast to Bostic and Gabriel and Gabriel and Rosenthal, who focused on indirect housing market outcomes). The analysis by Ambrose and Thibodeau allows for substitution effects from other lenders and controls for economic conditions and demographic factors. They concluded that the AHGs have had quite a limited effect on mortgage supply.

Ambrose and Pennington-Cross (2000) used data gathered under the Home Mortgage Disclosure Act (HMDA) to study how local economic risk factors affect FHA and GSE activity. FHA and GSE activity is measured by their market shares of new mortgages across metropolitan statistical areas (MSAs), excluding refinancing mortgages and loans later sold from the GSE portfolios. They found that the FHA market share is significantly higher in MSAs with higher proportions of underserved households, whereas just the opposite is true for GSE shares in these areas.

The three major real-estate-based trade associations have taken public positions regarding the GSE affordable housing goals. The National Association of Realtors (2004) and the Mortgage Bankers Association (2006) both claim that the AHGs have been set too high. Their concerns include possible over-investment in multifamily rental units, negative impacts on the FHA program if the GSEs “cherry pick” the better risks, and a possible overall decline in lending to middle-income markets. The National Association of Homebuilders (2006), in contrast, is directly supportive of the enforcement of the AHGs. This is not surprising, since their members gain from any increase in housing demand.

Finally, the General Accounting Office (1998) reviewed HUD’s oversight of the GSEs, making three primary recommendations. First, the GAO recommended that HUD adopt less conservative goals; the agency responded by raising the goals in 2004. Second, the GAO report urged HUD to develop more expertise in assessing the GSE performance data and in evaluating whether the GSE financial activities are consistent with their housing mission. Finally, the GAO urged HUD to conduct further research to determine

the extent to which the AHGs are creating a net increase in housing market opportunities for low-income families and underserved areas.

III. The Economic Costs of Housing Subsidies

Direct expenditures, tax expenditures, and guarantee costs are all public subsidies, representing either current or expected future liabilities of the U.S. Treasury. In this section, we review the economic costs of providing these subsidies.

A. Subsidies Through Direct Expenditures

Among the subsidy categories, only direct expenditures are observable in federal budget documents, which report both government outlays, (i.e., actual expenditures) in any fiscal year and budget authority, (i.e., the aggregate new federal commitment of public funds which may be spent in current or future years). Table 2 reports the net budget authority and federal outlays for low-income housing assistance during the past three decades. All of these programs are administered by HUD with the exception of those administered by Rural Housing Service of the U.S. Department of Agriculture. As indicated in the table, since 1976 federal expenditures on low-income housing have increased by 225 percent in real terms, from \$16.8 billion to \$37.7 billion in 2006 dollars.

Spending on major HUD programs, public housing, project-based assistance, and vouchers has more than quadrupled – from \$7.9 billion to \$31.5 billion, while spending on other low-income housing programs declined by more than a quarter from \$8.9 billion to \$6.2 billion. This reduction is due entirely to the demise of the Rural Housing Program, whose expenditures declined by more than ninety percent in real terms.

Table 2. Net Budget Authority and Government Outlays for Low Income Housing Assistance
Fiscal Years 1976-2007, Millions of 2006 Dollars

Fiscal Year	Net Budget Authority			Federal Outlays		
	Major HUD Programs ¹	Other ²	Total	Major HUD Programs ¹	Other ²	Total
1976	\$62,330	\$11,976	\$74,307	\$7,902	\$8,859	\$16,761
1977	85,096	14,169	99,265	8,664	10,332	18,996
1978	89,988	14,117	104,104	10,084	11,982	22,067
1979	63,384	15,761	79,145	10,974	10,275	21,249
1980	64,789	19,193	83,982	12,877	11,390	24,267
1981	56,411	16,523	72,935	16,045	10,901	26,946
1982	28,455	16,323	44,778	16,891	10,217	27,107
1983	19,480	14,188	33,668	18,527	9,094	27,621
1984	23,363	15,796	39,158	19,867	8,235	28,102
1985	45,652	13,041	58,693	43,269	8,819	52,089
1986	19,545	7,007	26,552	20,746	7,452	28,198
1987	16,181	6,259	22,440	20,761	2,976	23,737
1988	15,369	12,659	28,028	22,053	7,427	29,480
1989	14,203	9,587	23,790	22,568	7,444	30,011
1990	15,873	12,808	28,681	23,607	6,102	29,708
1991	27,278	6,973	34,251	24,115	6,696	30,811
1992	23,721	7,511	31,232	25,153	4,551	29,704
1993	25,027	5,371	30,398	27,618	3,209	30,827
1994	23,967	6,514	30,480	29,345	3,798	33,143
1995	15,376	6,545	21,921	32,553	4,864	37,417
1996	16,839	5,430	22,269	30,519	4,164	34,684
1997	10,472	4,911	15,383	30,808	4,205	35,013
1998	15,428	5,834	21,263	29,795	4,834	34,630
1999	18,145	6,350	24,495	27,565	5,138	32,704
2000	14,720	6,228	20,948	27,980	4,955	32,935
2001	21,868	6,899	28,767	28,513	5,747	34,259
2002	23,099	6,274	29,373	30,746	5,794	36,540
2003	24,428	7,076	31,504	32,237	5,626	37,863
2004	24,826	6,098	30,924	32,486	5,755	38,240
2005	24,547	5,376	29,923	32,297	5,613	37,910
2006	24,933	5,578	30,511	31,945	6,001	37,946
2007	24,731	5,488	30,219	31,525	6,200	37,725

Source: OMB, Public Budget Database, Budget of the United States, Fiscal Year 2007.

Note: 1 Includes Public Housing, Project-Based assistance, and Voucher programs.

2 Includes programs for the elderly, disabled, homeless, Indian programs, and rural housing administered by USDA.

Despite the large increase in expenditures on low-income housing programs, net budget authority issued by congress has declined substantially, by about forty percent during the period, from \$74.3 billion in 1976 to \$30.2 billion in 2007. This reflects a gradual shift in low-income housing assistance from project-oriented to tenant-oriented subsidies. New long-term commitments under production-oriented approaches were sharply curtailed in the early 1980s, but pre-existing commitments under the public housing and Section 8 new construction programs continue to provide shelter for a substantial number of low-income households. Table 3 reports the distribution of expenditures during the past few years among major HUD programs: public housing, other project based assistance, and vouchers. By 1990, vouchers represented 64 percent of program expenditures. Vouchers are currently 73 percent of program expenditures. As long-term commitments entered into in the 1980s expire in the next few years, it is expected that tenants will be offered vouchers, further increasing HUD's reliance on demand side assistance to provide housing support to low-income households.

B. Subsidies Through Tax Expenditures

Table 4 reports comparable information on federal government tax expenditures. Tax expenditures for low-income households include tax credits distributed for the construction of low-income housing under the LIHTC and the foregone revenue on tax-exempt multifamily housing bonds. The former program has grown from \$1.2 billion in 1991 to \$4.0 billion in 2006 (in 2006 dollars). Multifamily housing bond programs adopted by the states are smaller; tax expenditures on them have declined from about a billion dollars to half that over the same period. In part, this reflects cyclical declines in interest rates which have made these bonds less attractive to investors.

Table 3. Federal Outlays for HUD Supply and Demand Side Programs

Fiscal Years 2000-2007, Millions of 2006 Dollars

Fiscal Year	Supply side	Demand side
2000	\$9,285	\$18,696
2001	9,370	19,143
2002	9,967	20,780
2003	9,278	22,959
2004	8,625	23,860
2005	8,259	24,037
2006	7,908	24,037
2007	7,428	24,097

Source: Office of Management and Budget, Public Budget Database, Budget of the United States Government, Fiscal Year 2007.

Supply-side programs include Public Housing and Project-based assistance.

Demand-side programs include certificates and vouchers.

Quantifying the tax expenditures that support owner occupied housing is a surprisingly controversial undertaking, in good part due to the method applied by the US Office of Management and Budget (OMB), the agency required to provide estimates of tax expenditures (under the Congressional Budget Act of 1974). Tax expenditures must be measured against some benchmark tax system, so that the variances that are created by the actual tax system can be identified as revenue losses. The 1974 Act did not specify a benchmark tax system, but the OMB budget documents, at least since 1985, have applied what is termed the “normal tax baseline.” In contrast, most economists would endorse a baseline derived from a “comprehensive” or a “Haig-Simons” concept of income, that is, the annual net increment to wealth created by an individual’s economic activities.

Income from owner-occupied housing is an important economic activity in which the two benchmark measures lead to significantly different estimates of tax expenditures. Specifically, if we apply the comprehensive income benchmark, the net income from an investment in owner-occupied housing is the imputed rental income yielded by the property minus the expenses incurred in producing that income: mortgage interest payments; property tax payments; maintenance; and economic depreciation. This

definition of taxable net income conforms precisely to the definition applied in the current tax code to taxpayer investments in rental properties. This definition also provides the standard for evaluating the tax expenditures for owner-occupied housing that are embedded in the current tax code. Since imputed rental income is not currently taxed, it represents a tax expenditure. By the same token, since depreciation is not currently allowed as a deductible expense for owner-occupied housing, it is a negative tax expenditure – an instance of over-taxation. Mortgage interest and property tax payments are not tax expenditures, since they are appropriate deductions under the comprehensive income concept, and, indeed, the current tax law does allow these deductions.

In contrast, under the normal tax baseline concept, owner occupied housing income and expenses are treated as fundamentally untaxed. Therefore, the currently allowed mortgage interest and property tax deductions are counted as the tax expenditures for owner-occupied housing.³

The U.S. budget for fiscal year 2006 was the first one that provided proper estimates of aggregate tax expenditures for owner-occupied housing based on the comprehensive income benchmark, including historic values back to 2004. The appropriate total, shown in the first three columns of Table 4, is the sum of tax expenditures on net imputed rental income (\$29 billion), the mortgage interest deduction (\$64 billion), and the property tax deduction (\$20 billion).⁴

³ Alternatively, it could be argued that property taxes are payments for state and local government services, in which case the imputed income from these services should also be included as part of comprehensive net income. Or, if the imputed services are not taxed, then the property tax deduction might be treated as a tax expenditure.

⁴ This total is identical to the aggregate of gross rental income minus depreciation, repairs and maintenance.

Table 4. Federal Tax Expenditures for Housing, Fiscal Years 1980-2011(est)

(Millions of 2006 Dollars)

Fiscal Year	---Owner Occupied Homeowners---				Investor			
	Imputed Rental Income	Mortgage Interest	Property Tax	Capital Gains	Tax-exempt Bonds		LIHTC	Other ¹
					Homeowner	Multi-family		
1980	-	\$36,372	\$17,027	\$3,599	\$1,041	\$722	-	-
1981	-	42,427	19,218	3,391	1,443	916	-	-
1982	-	45,820	16,437	4,345	1,779	777	-	-
1983	-	39,015	15,025	3,611	2,551	1,332	-	\$1,304
1984	-	40,628	15,762	4,396	2,681	1,305	-	1,215
1985	-	42,815	16,091	4,500	2,911	1,304	-	1,382
1986	-	51,319	14,434	4,907	3,457	2,091	-	4,570
1987	-	56,979	16,867	7,765	3,296	2,271	\$49	918
1988	-	53,604	16,077	10,570	2,810	1,966	255	2,714
1989	-	52,484	15,450	23,371	2,909	1,873	437	9,395
1990	-	55,850	14,148	23,578	2,608	1,575	171	13,227
1991	-	57,943	15,287	22,592	3,111	1,460	1,153	11,777
1992	-	58,832	16,859	24,136	2,582	1,487	1,542	10,739
1993	-	65,390	17,527	24,019	2,303	1,343	2,074	10,848
1994	-	63,728	18,449	28,068	2,316	1,276	2,533	8,981
1995	-	61,755	19,620	24,841	2,325	1,188	2,903	8,342
1996	-	59,681	19,967	24,657	2,216	948	3,265	7,654
1997	-	60,443	20,840	30,474	2,156	998	2,834	8,008
1998	-	63,065	21,676	21,316	1,049	183	3,806	9,899
1999	-	68,400	25,494	21,630	1,088	186	3,389	12,041
2000	-	70,600	25,935	21,718	925	187	3,760	12,265
2001	-	73,846	25,653	21,853	916	183	3,686	12,626
2002	-	71,453	24,451	22,102	978	202	3,697	9,360
2003	-	67,000	24,199	22,194	997	307	6,803	8,775
2004	\$26,234	65,558	21,262	31,717	1,088	384	3,905	7,340
2005	29,528	64,176	19,730	37,157	960	423	4,006	17,758
2006 est	29,720	72,060	15,020	39,750	990	430	4,060	18,130
2007 est	32,497	78,146	12,535	42,958	1,018	440	4,159	18,455
2008 est	36,069	85,935	12,633	47,449	1,116	489	4,364	19,473
2009 est	39,758	92,461	12,555	58,614	1,184	519	4,609	20,451
2010 est	43,824	98,812	12,447	77,167	1,213	528	4,844	21,254
2011 est	48,304	105,955	22,438	85,230	1,253	538	5,108	22,369

Source: Office of Management and Budget, Budget of the United States Government, Fiscal Year 1982-2007.

Note: 1 Includes 'Deferral of income from post 1987 installment sales', 'Exception from passive loss rules for \$25,000 of rental loss' and 'Accelerated depreciation of rental housing (normal tax method)'.
of rental loss' and 'Accelerated depreciation of rental housing (normal tax method)'.

The favorable treatment of capital gains on owner occupied housing is another element of subsidy, although capital gains on other assets (such as corporate equities) also receive tax benefits, such as reduced tax rates and a step-up in basis upon death.

C. The Distribution of Housing Subsidies by Income Class

The housing subsidies provided by direct federal expenditures and federal tax expenditures on owner occupied housing can be calculated from federal budget data and from federal tax returns. For the most part, the distribution of these subsidies by the income class of the beneficiary can be calculated as well. For some of these subsidies, it is possible to estimate their distribution across households of various income classes. For example, the distribution of federal tax expenditures for owner occupied housing can be calculated from IRS records of individual tax returns. It may be safe to assume that most of the subsidy in direct expenditures on low-income housing is enjoyed by households in the bottom quintile of the income distribution. (This assumes that the supply of low-income housing is sufficiently elastic that these subsidies do not increase prices.) Similarly, tax expenditures for multifamily housing bonds and for the Low-Income Housing Tax Credit may be presumed to accrue to households in the bottom two quintiles of the income distribution. (But this is much less clear. For example, it is widely reported that the increased housing investment stimulated by the LIHTC is far less than the cost imposed on the federal treasury. See Quigley, 2000, for a discussion.)

Table 5 presents estimates of the distribution of these subsidies by income quintile in a representative year. The distribution of benefits by income is dominated by the distribution of homeowner subsidies. This table accounts for about \$167 billion of the roughly \$200 billion in housing subsidies distributed by the federal government. But it is

hard to see that the remaining categories – homeowner bonds (\$1.1 billion, Table 4), tax expenditures for housing investors (\$7.7 billion, Table 4), and housing credit guarantees (\$25.2 billion in 2003, Table 6) – provide much benefit to households in the bottom two quintiles of the income distribution. Indeed, as we discuss below, it appears that about half of the public expenditures for housing credit guarantees benefit investors and not housing consumers at all.

In any case, the distributions reported in Table 5 do show that housing subsidies, as a fraction of income, decline at higher incomes. They are about ten times as large – as a fraction of income – for those at the lowest quintile as they are at the highest quintile of the income distribution. In this sense, these housing subsidies are progressive with respect to income. But the table also indicates that the largest shares of these subsidies go to the richest households in the US economy. Sixty-one percent of the dollars go to the richest forty percent of households, and 37 percent of the dollars go to the richest one fifth of American households.

Table 5. Estimated Distribution of Housing Subsidies by Income Quintile, 2004
(Billions of 2006 Dollars)

	Quintile					Total
	First	Second	Third	Fourth	Fifth	
Average Income (2006 Dollars)	\$10,983	\$27,927	\$47,060	\$74,022	\$158,041	\$63,998
Low-Income Housing Assistance	\$32.4	\$4.8	\$1.8	\$0.6	\$0.1	\$39.8
Tax Expenditure	\$1.5	\$7.0	\$17.9	\$39.7	\$61.0	\$127.3
Total	\$33.9	\$11.8	\$19.7	\$40.3	\$61.1	\$167.1

Source: Cushing N. Dolbeare, et al, "Changing Priorities", Washington, D.C.: National Low Income Housing Coalition, October, 2004. Carasso, Adam, et al, "Making Tax Incentives for Homeownership More Equitable and Efficient", Washington, D.C.: Urban Institute Discussion Paper No. 21, June 2005. See text for assumptions.

D. Subsidies Provided Through Credit Guarantees

For federal credit guarantees and federal insurance programs, the extent of the subsidy is somewhat more difficult to estimate, and the distribution of subsidies among recipients is a good bit more problematic. Large federal subsidies are provided to the GSEs. Some GSE benefits are a direct result of their federal charters, which allow them to be treated, for some purposes, as agencies of the federal government rather than as private profit-seeking firms. For example, the GSEs are exempt from state and local income taxation and from Securities and Exchange Commission registration requirements and fees. The GSEs may use the Federal Reserve as their fiscal agent, and they are provided a \$2.25 billion line of credit at the U.S. Treasury. GSE debt is eligible for use as collateral for public deposits, for unlimited investment by federally chartered banks and thrifts, and for purchase by the Federal Reserve in open-market operations. GSE securities are also exempt from the provisions of many state investor-protection laws. These privileges provide direct monetary savings to the GSEs, privileges that have not been granted to any other shareholder-owned companies. Estimates by CBO of the value of this special treatment are shown in the first column of Table 6.

However, the more important public subsidy to the GSEs arises from the government's implicit guarantee of all their debt and all their MBS obligations. Other financial institutions would surely be willing to pay a significant fee to receive a comparable guarantee from the federal government. This special treatment of the GSEs arises in part because the federal government views the securities issued by these organizations as safe and sound – if not, the government would not have exempted the GSEs from the protective regulations governing other similarly situated private entities.

Table 6
Federal Subsidies for Housing Credit Insurance and Guarantees, Fiscal Years 1995-2003
(Millions of 2006 Dollars)

Fiscal Year	Government Sponsored Enterprises				Veterans Affairs
	Tax and Regulation Treatment	Debt Issued	MBS Issued	Total	Total
1995	\$812	\$4,752	\$3,211	\$8,775	\$442
1996	952	4,646	3,767	9,366	100
1997	1,002	5,544	3,450	9,995	764
1998	1,277	11,100	4,147	16,525	1,292
1999	1,416	12,257	5,047	18,720	1,441
2000	1,380	10,308	4,217	15,905	1,673
2001	1,962	13,966	8,013	23,941	591
2002	2,482	12,922	9,214	24,618	890
2003	1,457	13,694	10,078	25,229	1,524

Source: Congressional Budget Office (CBO), "Federal Subsidies and the Housing GSEs" and "Updated Estimates of the Subsidies to the Housing GSEs," Washington, DC: US Government Printing Office, 2001 and 2004. Office of Management and Budget, Public Budget Database, Budget of the United States, Fiscal Year 2007.

Thus, despite the explicit statement in every prospectus disavowing a federal guarantee, the GSEs enjoy lower financing costs than those of similarly situated private firms.⁵

GSE debt obligations are classified as "agency securities," and are issued at interest yields somewhere between AAA corporate debt and U.S. Treasury obligations. This is despite the fact that the firms themselves merit a somewhat lower credit rating. (The Congressional Budget Office estimates that without GSE status the housing enterprises would have credit ratings between AA and A. See CBO, 2001.) An estimate of the cost of this implicit federal subsidy for the debt issued by the GSEs can be derived from the spread between the interest rates paid by the GSEs for the debt they issue and the rates paid by comparable private institutions. This comparison, in turn, depends upon the credit ratings, maturities, and other features of the bonds issued, as well as market

⁵ This benefit can be measured either in terms of the subsidized cost of GSE borrowing or in terms of the expected costs that would be imposed on the government if it had to make restitution to GSE bondholders and MSB investors.

interest rates and credit conditions. Quigley (2006) provides a detailed review of estimates of this spread, reported in different studies using different methodologies. On the basis of this evidence, the CBO has concluded that the overall funding advantage enjoyed by the GSEs is about 41 basis points. The second column in Table 6 shows the CBO estimates of the subsidies provided to the GSEs for the debt they issue. The subsidy provided to GSE debt, in 2006 dollars, is estimated to be \$4.7 billion in 1995, and \$13.7 billion in 2003. In large part, the tripling of this subsidy reflects the rapid growth of Fannie Mae and Freddie Mac during this eight year period.

The federal implicit guarantee provides an analogous advantage to GSE-issued MBS compared with MBS issued by other private entities. The market requires a greater capital backing for a private guarantee than for a guarantee made by Fannie Mae or Freddie Mac, and the provision of this additional capital reserve is costly to private firms. The CBO has also estimated that the advantage enjoyed by the GSEs is 30 basis points. When this is applied to the MBS issued by the GSEs in 1995, the estimated subsidy is \$3.2 billion (in 2006 dollars). By 2003, the subsidy had grown to \$10.1 billion, again reflecting the rapid growth in Fannie Mae and Freddie Mac during the recent period.

The combined GSE subsidies in 2003, the most recent available estimates, amounted to over \$25 billion in 2006 dollars, as summarized in Table 6. These subsidies could, in principle, either be passed through to mortgage borrowers in the form of lower mortgage rates, or retained as profits by the GSEs. If an equivalent subsidy were provided to a competitive industry, it could be presumed that most, if not all, of the subsidy would be passed through to final consumers. There is evidence, however, that Fannie Mae and Freddie exercise considerable market power. (See Hermalin and Jaffee, 1996). However,

even duopolists have incentives to pass forward part of a subsidy, and there is evidence that a part—perhaps about half--of this subsidy is passed through by Fannie and Freddie to mortgage borrowers.⁶ The residual fraction of this benefit is retained by the shareholders of the GSEs. This residual arises from the competitive advantage of the GSEs over other financial institutions which is conferred by their federal charter.

As noted, estimates of the reduction in mortgage interest rates attributable to this subsidy have some range -- around, say, 40 basis points. (See Quigley, 2006, Table 3.) If the conforming limit for GSE loans were set low enough, more of the benefits of this interest-rate reduction would accrue to moderate income households. But the limit is indexed to the national average home price as estimated by the Federal Housing Finance Board. In 2007 conforming mortgages could be written for an eighty percent loan on a property selling for \$521,250 (\$781,875 in Alaska and Hawaii).

E. Summary

As indicated in Tables 2, 4, and 6, the most recent estimates of federal subsidies for housing total \$221.1 billion: \$37.9 billion in 2006 dollars in government outlays for low-income housing assistance, \$156.5 billion in federal tax expenditures for housing, and \$26.7 billion in credit subsidies.

⁶ Differing estimates of the reduction in mortgage rates created by the subsidy have generated a quite contentious literature. Perhaps the lowest estimate, 7 basis points, is provided by Wayne Passmore, a staff economist at the Federal Reserve, Passmore (2005). (See also Passmore, *et al*, 2005.) A much higher estimate is provided by Blinder, Flannery, and Kamihachi (2004) in a study funded and published by Fannie Mae. See Quigley (2006) for a detailed comparison.

IV. GSE Policy and Housing Policy Reform

A. Background

Recent discussions of GSE reform were initiated by the Federal Housing Enterprise Safety and Soundness Act of 1992, which created a four-agency taskforce (composed of representatives of HUD, the Treasury Department, the Government Accountability Office, and CBO) to study the desirability and feasibility of privatizing Fannie Mae and Freddie Mac. The four agencies issued separate reports in 1996. HUD (1996) recommended against privatization, concluding that “the benefits achieved from full privatization would not offset the financial uncertainties and likely increases in borrowing costs that would be associated with full privatization.” The other three agencies also provided extensive reports, but made no specific recommendations. Congress took no action upon receipt of the agency reports, and activity which had been directed to GSE reform slowed, but did not disappear. For example, starting in 2000, the American Enterprise Institute and an organization now called FM Policy Focus initiated a series of conferences, publications, and web pages with a focus on GSE reform.⁷ Congress also began to consider a series of GSE reform bills, starting with H.R. 3703, introduced in February 2000 by Congressman Richard Baker, the chairman of the GSE subcommittee of the House Financial Services Committee.⁸

Corporate scandals, starting with Enron in 2001, also focused concern on the safety and soundness of the GSEs, provoking renewed discussions of GSE reform. By

⁷ The American Enterprise Institute activities were part of its Financial Deregulation Project, directed by Peter J. Wallison; <http://www.aei.org/research/contentID.20040927152122935/default.asp>. Details of FM Policy Focus are available at <http://www.fmpolicyfocus.org/>.

⁸ Wallison (2006) provides a very careful analysis of these bills and others which were introduced, but not enacted.

2002, Federal Reserve Chairman Alan Greenspan publicly expressed concerns for GSE “imbalances” and systemic risks (Greenspan 2002). Freddie Mac significantly added to these concerns when it announced in early 2003 that it had delayed the release of its audited financial results for 2002 and that a restatement of earnings was required going back to 2000. The proximate cause of the delay was the replacement of Freddie Mac’s auditing firm, Arthur Andersen (a casualty of the Enron debacle). The new auditors, PricewaterhouseCoopers, required the restatements. The details of an accounting and operational scandal at the firm were first publicly released in July 2003, in a report commissioned by the Directors of Freddie Mac. (See Baker Botts LLC, 2003.) Later that year, the Office of Federal Housing Enterprise Oversight, the agency within HUD responsible for supervising GSE safety and soundness, issued its own scathing critique (OFHEO, 2003). Freddie Mac’s annual financial reports are still delayed, and it has been unable to publish audited quarterly reports.

The Freddie Mac accounting errors, quite naturally, raised the concern that Fannie Mae might have comparable problems, and OFHEO began its own study of the firm, released in September 2004 (OFHEO, 2004). A special report commissioned by the Directors of Fannie Mae (Paul, Weiss, Rifkind, Wharton & Garrison, 2006) and a final report by OFHEO (2006) followed.⁹

There was also increasing recognition that the GSEs were imposing a potentially very large systemic risk on the U.S. financial system. Jaffee (2003) documented the extent of interest rate risk that was embedded in the GSE retained-mortgage portfolios and demonstrated that this risk was imperfectly hedged against interest rate volatility. Fed

⁹ Many believe that the Fannie Mae problems may be even more severe, since it seems the firm had overstated its earnings, in contrast to Freddie Mac which had generally understated its earnings (in order to smooth its reported income).

Chairman Alan Greenspan's 2004 testimony before the Senate Committee on Banking, Housing and Urban Affairs (Greenspan, 2004) contributed a more precise direction to GSE reform, by referring explicitly to limits on the size of the GSE retained-mortgage portfolios, as a means to control the systemic risks imposed on the financial system. Greenspan continued to promote quantitative portfolio limits in his speeches and testimony throughout 2004 and 2005. Several bills to limit or regulate the investment portfolios of the GSEs were considered by the 108th Congress, but none were enacted.

B. Current Congressional Proposals

In May 2005, the U.S. Treasury submitted a specific proposal for "portfolio limitations," which were reflected in Senate Bill S. 190 which passed the Senate Banking Committee in July 2005. During the same period, an alternative House bill, H.R. 1461, was developed and subsequently passed. Common provisions of the two bills include a new agency to replace OFHEO with enhanced powers and oversight responsibility for the GSEs, and the exemption of this agency from the annual appropriations process. The bills differ, however, in two key respects. (See Congressional Research Center, 2005a, 2005b for further discussion.)

First, the Senate proposal would shrink the GSE retained-mortgage portfolios. In contrast, the House proposal would expand the pool of mortgages the GSEs could purchase and retain by raising the conforming mortgage loan limits. Advocates of limitations on the GSE retained-mortgage portfolios have firmly criticized the latter proposal on this basis. Wallison and Stanton (2005), for example, argue that the status quo would be preferable to the passage of the House bill.

Second, the House bill proposes to expand GSE support for low-income housing through an “Affordable Housing Fund,” fueled by an annual charge (increasing from 3.5 percent to 5.0 percent over five years) on each firm’s after-tax income. Had this bill been in effect from 2000, it would have raised close to \$600 million from the two GSEs in 2003. The resources of this fund would be distributed to non-profit entities chosen by the GSEs, which in turn would apply the funds in support of low-income housing endeavors based on five goals (Congressional Research Center, 2005b):

- i. to increase home ownership by families at or below 50 percent of area median income;
- ii. to increase mortgage funds in designated low-income areas;
- iii. to increase the supply of rental and owner-occupied housing for families at or below 50 percent of area median income;
- iv. to increase investment in public infrastructure in connection with related affordable housing goals;
- v. to leverage funding from other sources.

The Affordable Housing Fund (AHF) provided for in House proposal has been contentious. Advocates of the bill, most prominently Representative Barney Frank of Massachusetts, consider the AHF to be a sensible, housing-directed, *quid pro quo* for the subsidies provided to the GSEs. (See Frank, 2005.) However, critics of this legislation (e.g., Wallison and Stanton, 2005), have suggested that the GSEs could direct the funds to politically-friendly non-profit entities. During the floor debate, H.R. 1461 was amended to prohibit the use of any AHF resources for “political purposes,” but the bill’s opponents remain skeptical. In particular, this proposed legislation aligns the incentives

for affordable housing with the profit incentives of the GSEs -- the greater the GSE profits, the greater the GSE contributions to the AHF.

C. Current Policy Options

As embodied in the competing Congressional proposals, there are two distinct policy objectives regarding the GSEs. First there is wide concern, as illustrated by the Senate bill, that GSE retained-mortgage portfolios create significant risks for both U.S. taxpayers and the U.S. financial markets as a whole. Second, there is broad recognition, as illustrated by House bill, that the advantages conferred on the GSEs should be directed towards expanding homeownership opportunities for low-income families.

In principle, these two objectives are not incompatible. However, the House bill ties additional resources for low-income homeownership directly to the profits of the GSEs. In large part, these profits are derived from the retained-mortgage portfolios of the GSEs. The House bill also calls explicitly for raising the conforming limit for GSE mortgage purchases, a change that would raise GSE profits, but would also increase the size of the retained-mortgage portfolios and the risks they create. Thus, as drafted, the Senate and House bills are incompatible.

But there are actions that could further both objectives. Several concrete proposals have been offered for controlling the risks inherent in the retained-mortgage portfolios of the GSEs. Several proposals were advanced by the Congressional Budget Office a decade ago (CBO, 1996). More recent and comprehensive proposals have been put forward by Frame and White (2005), Jaffee (2006), and Quigley (2006). These actions include direct and indirect controls on portfolio magnitudes and risks, regulating more tightly the mortgages eligible for purchase, and imposing fees for the issuance of debt. Many reform

proposals have recommended that severe limits be imposed upon GSE portfolios (Eisenbeis, *et al*, 2006). These limits could be imposed rather easily by the natural and orderly liquidation of existing positions. (See Jaffee, 2005, for a specific mechanism.) These limits would certainly reduce GSE profits and thus would limit possible support for affordable housing.

Alternatively, the systematic risk imposed by GSE portfolios could be reduced or controlled indirectly. For example, the GSEs could be required to hedge fully all interest rate risk in their portfolios, or they could be required to hold substantially larger capital reserves. The former policy would be difficult to monitor, especially since it is always in the profit interest of the entities to remain incompletely hedged in interest rate exchanges. Either of these requirements would also affect GSE profits.

It would also be administratively easy to force the GSEs to direct their mortgage purchases to smaller mortgages, thus increasing their incentives to support the housing needs of lower income families. Of course, this would also reduce GSE support of the mortgage needs of middle and higher income families, and this may explain why it has received little political support so far.

Finally, as an administrative matter, it would be rather easy to levy an explicit fee upon the GSEs to compensate the federal government for the implicit guarantee it now provides without charge to the GSEs on all their debt issues. This would allow the GSEs to maintain, if they wished, their retained-mortgage portfolios, but would also provide a financial incentive for them to refocus on the issuance of MBS. An analogous policy was

applied with remarkable success to another GSE, the Student Loan Marketing Association, Sallie Mae.¹⁰

If implemented, this latter proposal would also reduce the profits of the GSEs. But it could also raise considerable public revenue, compensating the federal government for the implicit guarantee provided. Of course, these revenues could be used to support the objective of increased housing affordability for lower income households.

The appropriate guarantee fee is not obvious. But it is surely not zero. One way to further both objectives would be to impose a guarantee fee and to use the proceeds to support more affordable housing in some specific program. Suppose, for example, that an annual user fee of as little as 4 basis points were imposed upon GSE debt. Based upon the GSE debt outstanding at the end of 2005, the fee would raise about \$600 million. This is about the same revenue as would be raised through the tax on GSE income stipulated in the House bill. Suppose, instead, that an annual user fee of 40 basis points were imposed upon GSE debt. This fee would raise about \$6 billion, roughly ten times the revenues expected from passage of the House bill. The revenue raised from a 40 basis point charge is also quite close to congressional estimates of the portion of the GSE subsidy which is retained by the two firms. (This estimate is \$6.2 billion. See CBO, 2004, Table 4.) \$6.2 billion also happens to equal that part of total GSE profits in 2003 that is in excess of an eleven percent allowed rate of return. Thus, this charge could also be viewed as a rough tax on the “excess profits” of the GSEs.¹¹

¹⁰ The Omnibus Budget Reconciliation Act of 1993 imposed a 30 basis point annual fee on Sallie Mae’s retained portfolio of student loans. As a result, Sallie Mae supported the Student Loan Marketing Association Reorganization Act of 1996 which ultimately led to the termination of all its GSE activities in 2004. (See Lea, 2006, for a discussion.)

¹¹ The last year for which GSE profits are reported is 2003. In that year, the combined profits of Fannie Mae and Freddie Mac, in excess of an eleven percent return on equity were \$6.2 billion.

Of course, the GSE are likely to respond to this higher user fee by reducing the size of their retained-mortgage portfolios, so that a 40 basis point fee would raise less than \$6 billion. But, of course, a goal in imposing the fee is to induce the GSEs to rely more heavily on issuing mortgage-backed securities to third-party investors and less heavily on managing their retained-mortgage portfolios. This is, of course, the desired outcome. But the revenue raised in achieving this could provide more than inframarginal support for affordable housing.

Suppose further, that the revenues generated by a 40 basis point guarantee fee were deposited in a trust fund managed by HUD to issue additional vouchers under the current housing choice voucher program. As indicated in Table 3, these revenues could be used to increase the supply of vouchers by about 25 percent, contributing as much as \$6 billion to the existing expenditures of \$24 billion. Currently, less than forty percent of American households below the poverty line are served by low-income housing programs. Thus, this augmentation could make a real difference.

V. Concluding Comments

Federal support for housing in the U.S. is currently provided by a diverse array of programs: direct expenditure programs administered by HUD; tax expenditures based on the special treatment of owner-occupied housing and the Low-Income Housing Tax Credit (LIHTC); and the operations of the government sponsored enterprises, Fannie Mae and Freddie Mac. Among these, the HUD programs and the LIHTC are directed at housing for low-income families, while tax expenditures for owner-occupied housing and most GSE activities support middle and upper income housing. A political will to

augment federal support for low-income housing remains, but budget resources are very scarce.

At the same time, there is much concern for the financial risks imposed by the GSEs on U.S. taxpayers and the financial system. This concern is recognized by the current Senate proposal to limit the size of the GSE retained-mortgage portfolios. An alternative proposal originating in the House would tax GSE profits and use the receipts for low-income housing. The Senate Bill achieves GSE reform while the House bill provides a creative approach to funding housing assistance. But neither bill appears to have sufficient political support for passage.

We propose instead that a user fee be imposed on the debt issued by the GSEs and that the proceeds be applied to expand the existing HUD voucher program. Imposition of a very modest user fee, 4 basis points, would yield as much revenue for increased low-income housing support as the current House bill. Imposition of a 40 basis point fee would provide incentives for more efficient portfolio investment by the GSEs, and it would increase the resources available for housing vouchers for low-income households by as much as twenty five percent.

References

Ambrose, Brent W. and Anthony Pennington-Cross (2000), "Local Economic Risk Factors and the Primary and Secondary Mortgage Markets." Regional Science and Urban Economics, Vol. 30 Issue 6, pp. 673-701.

Ambrose, Brent W. and Thomas G. Thibodeau (2004), "Have the GSE Affordable Housing Goals Increased the Supply of Mortgage Credit?" Regional Science and Urban Economics, Vol. 34 Issue 2, 2004: 263-73.

Baker Botts LLP (2003), "Report to the Board of Directors of The Federal Home Loan Mortgage Corporation: Internal Investigation Of Certain Accounting Matters." www.freddiemac.com/news/board_report

Blinder Alan, Mark Flannery, and James Kamihachi (2004), "The Value of Housing-Related Government Sponsored Enterprises: A Review of a Preliminary Draft Paper by Wayne Passmore, Fannie Mae Papers," Vol. III, Issue 2.

Bostic, Raphael W. and Stuart A. Gabriel (2006), "Do the GSEs Matter to Low-Income Housing Markets?" Journal of Urban Economics, Volume 59, pp. 458-475.

Congressional Budget Office (CBO, 1996), "Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac," May 1996.

Congressional Budget Office (CBO, 2001), Federal Subsidies and the Housing GSEs. Washington, DC. US Government Printing Office.

Congressional Budget Office (CBO, 2004), Letter from Director Douglas Holtz-Eakin to Chairman Richard C. Shelby, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, April 8, 2004.

Congressional Research Service (CBO, 2005a), "Government-Sponsored Enterprises (GSEs): Regulatory Reform Legislation, Updated October 27, 2005", RL32795, available online:

http://digital.library.unt.edu/govdocs/crs//data/2005/upl-meta-crs-7896/RL32795_2005Oct27.pdf

Congressional Research Service (CBO, 2005b), "GSE Reform: A New Affordable Housing Fund", RS22336, November 28, 2005, available online:

http://digital.library.unt.edu/govdocs/crs//data/2005/upl-meta-crs-7981/RS22336_2005Nov28.pdf?PHPSESSID=c3132413a5a381855d53e1b278c46b62

Eisenbeis, Robert A., W. Scott Frame, and Larry D. Wall (2006), "An Analysis of the Systematic Risks Posed By Fannie Mae and Freddie Mac and an Evaluation of the Policy Options for Reducing Those Risks," Federal Reserve Bank of Atlanta, Working Paper 2006-2, April 2006.

- Fannie Mae (2006), 2005 Annual Housing Activities Report, March 16, 2006.
- Frame, Scott and Lawrence White (2005), “Fussing and Fuming over Fannie and Freddie: How Much Smoke, How Much Fire?” Journal of Economic Perspectives, Vol. 19, No. 2, Spring 2005.
- Frank, Barney (2005), “House Approves Raising Loan Limits for High Housing Cost Areas,” Press Release, October 27, 2005.
- Freddie Mac (2006a), 2005 Annual Housing Activities Report, March 16, 2006.
- Freddie Mac (2006b), Information Statement and Annual Report to Stockholders for the Fiscal Year ended December 31, 2005, June 28, 2006.
- Gabriel, Stuart and Stuart Rosenthal (2005), “Homeownership in the 1980s and 1990s: Aggregate Trends and Racial Gaps,” Journal of Urban Economics, Volume 57: pp. 101-127
- Greenspan, Alan (2002), “Finance: United States and Global,” remarks before the Institute of International Finance, April 22, 2002, available at: <http://www.federalreserve.gov/boarddocs/Speeches/2002/20020422/default.htm>
- Greenspan, Alan (2004), “Government-Sponsored Enterprises,” testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 24, 2004
- Greenspan, Alan (2005), “Testimony of Chairman Alan Greenspan,” Hearing on Regulatory Reform of the Government-Sponsored Enterprises, U.S. Senate Committee on Banking, Housing, and Urban Affairs, April 6, 2005.
- Hermalin, Benjamin and Dwight Jaffee (1996), “The Privatization of Fannie Mae and Freddie Mac: Implications for Mortgage Industry Structure,” in Studies on Privatizing Fannie Mae and Freddie Mac. Washington, DC: HUD: 225-302.
- Jaffee, Dwight (2005), “On Limiting the Retained-Mortgage Portfolios of Fannie Mae and Freddie Mac.” Working Paper 294, University of California, Berkeley, Fisher Center.
- Jaffee, Dwight (2003), “The Interest Rate Risk of Fannie Mae and Freddie Mac,” Journal of Financial Services Research, 24:1 pp. 5-29.
- Jaffee, Dwight (2006), “Reining in Fannie Mae and Freddie Mac,” Regulation, Vol. 29, No. 3, pp. 22-27.
- Lea, Michael (2005), “Privatizing a Government Sponsored Enterprise: Lessons from the Sallie Mae Experience,” paper presented at Fixing the Housing Finance System, a conference at the Wharton School, April 2005. The paper is also available as: Policy Brief 2006-PB-09, the Networks Financial Institute, Indiana State University, available at <http://www.networksfinancialinstitute.org/policy-brief.asp>

Mortgage Bankers Association (2006), "GSE Affordable Housing Goals," April 2006, available at:

<http://www.mortgagebankers.org/files/Library/Issue%20Papers/0406/GSEAffordableHousingGoals.pdf>

National Association of Homebuilders (2006), "Record Number of Builders Carry Concerns to Capitol Hill," Nation's Building News, May 22, 2006, available at http://www.nahb.org/news_details.aspx?newsID=2640

National Association of Realtors (2004), "Comment on the Proposed Housing Goals for Fannie Mae and Freddie Mac," July 15, 2004, available at <http://www.realtor.org/gapublic.nsf/pages/gsegoalslet?OpenDocument>

Office of Federal Housing Enterprise Oversight (OFHEO, 2003), "Report of the Special Examination of Freddie Mac," December 2003.

Office of Federal Housing Enterprise Oversight (OFHEO, 2004), "Report of Findings to Date Special Examination of Fannie Mae Office of Compliance Office of Federal Housing Enterprise Oversight September 17, 2004.

Office of Federal Housing Enterprise Oversight (OFHEO, 2006), "Report of the Special Examination of Fannie Mae," May 2006.

Passmore, Wayne (2005), "The GSE Implicit Subsidy and the Value of Government Ambiguity," Real Estate Economics, Vol. 33, Issue 3, pp. 465-486.

Passmore, Wayne, Shane M. Sherlund, and Gillian Burgess (2005), "The Effect of Housing Government-Sponsored Enterprises on Mortgage Rates," Real Estate Economics, Vol. 33, Issue 3, pp. 427-63.

Passmore, Wayne, Roger Sparks, and Jamie Ingpen (2002), "GSEs, Mortgage Rates, and the Long-Run Effects of Mortgage Securitization," Journal of Real Estate Finance and Economics, Vol. 25, Issue 2/3, pp. 215-42.

Paul, Weiss, Rifkind, Wharton & Garrison LLP (2006), "A Report to the Special Committee of the Board of Directors of Fannie Mae," February 23, 2006.

Quigley, John M. (2000), "A Decent Home: Housing Policy in Perspective," Brookings-Wharton Papers on Urban Affairs, edited by William G. Gale and Janet Rothenberg Pack, Volume 1:53-100.

Quigley, John M. (2006), "Federal Credit and Insurance Programs: Housing," Federal Reserve Bank of St. Louis Review, Vol. 88, Issue 4: 281-309.

U.S. Department of Housing and Urban Development (HUD, 2004), "Regulatory Analysis for The Secretary of HUD's Final Rule on HUD's Regulation of The Federal National Mortgage Association (Fannie Mae) and The Federal Home Loan Mortgage Corporation (Freddie Mac)," October, 2004.

U.S. Department of Housing & Urban Development (HUD, 1996), “Privatization of Fannie Mae and Freddie Mac: Desirability and Feasibility,” July 1996.

U.S. Department of Housing and Urban Development (HUD, 2006), “HUD’s Regulation of Fannie Mae and Freddie Mac”, available on-line (9/4/2006) at:
<http://www.hud.gov/offices/hsg/gse/gse.cfm>

Wallison (2005), “H.R. 1461: A GSE "Reform That Is Worse than Current Law,” AEI Online, June 17, 2005,
http://www.aei.org/publications/filter.all,pubID.22705/pub_detail.asp

U.S. General Accounting Office (1998), “Federal Housing Enterprises: HUD’s Mission Oversight Needs to be Strengthened,” GAO/GTGD-98-173, July 1998.

Wallison, Peter (2006), “The Evolution of a Policy Idea: How Restrictions on the Size of the GSEs’ Portfolios Became the Central Issue in Reform of Their Regulation,” American Enterprise Institute, National Financial Institute Policy Brief, 2006-PB-03, March 2006.

Wallison, Peter and Thomas Stanton (2005), “H.R. 1461: A GSE ‘Reform’ That Is Worse Than Current Law,” AEI Online Papers and Studies, June 17, 2005, available at:
http://www.aei.org/publications/pubID.22705,filter.all/pub_detail.asp