The Housing Market and Economic Recovery

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February 16, 2011

Introduction

Chairman Biggert, Ranking Member Frank and members of the Committee, I am pleased to have the opportunity to appear today to discuss stops toward a greater involvement of the private sector in housing finance. In this short statement, let me make two major points:

- Adoption of appropriate housing finance policies will aid the pace of economic growth and job creation by stabilizing household balance sheets and clarifying single-family and multi-family investment incentives; and

- There are good, pro-growth reasons to re-think the policy tradition of providing support to residential housing through tax and regulatory subsidies to debt-financed owner-occupied housing.

Let me discuss these in turn.

The Framework for Macroeconomic Recovery

According to the National Bureau of Economic Research the recession began in December 2007. Their data show that there were 142.002 million jobs in December of 2007 – the average of payroll and household survey data. In June 2009, NBER's date for the end of the recession, the same method showed 135.257 million jobs, for a total job loss of 6.745 million attributed to the recession. These numbers are quite close to those using the Bureau of Labor Statistics non-farm payroll, which showed a loss of 6.803 million.

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* The opinions expressed herein are mine alone and do not represent the position of the American Action Forum. I am grateful to Cameron Smith, Michael Ramlet, and Matt Thoman for assistance.

There are glimmers of promise. Since December 2009, 1.1 million jobs have been added, bringing the U.S. to 130.712 million jobs. However at the same time, there are 14.5 million unemployed persons in the economy and many more discouraged workers. The peak in the size of the labor force was 155 million in October 2008, and is now estimated at slightly below 154 million.

For these reasons, the current unemployment rate of 9.0 percent likely understates the real duress. Using the BLS alternative unemployment rate (U-6), one finds that unemployed, underutilized and discouraged workers are 16.7 percent of the total. As evidence of the difficulties, the number of long-term unemployed (27 weeks or more) is currently 6.4 million and accounts for 44.3 percent of all unemployed persons.

These data reflect the fact that the U.S. has suffered a deep recession and is growing slowly. Over the course of the past several years, Administrations and Congresses have engaged in a number of counter-cyclical fiscal measures ("stimulus"): checks to households (the Economic Stimulus Act of 2008), the gargantuan stimulus bill in 2009 (American Recovery and Reinvestment Act), "cash for clunkers" (the Car Allowance Rebate System), and tax credits for homebuyers (the Federal Housing Tax Credit). As this Committee is well aware there is an ongoing debate regarding the effectiveness of these measures in mitigating the natural course of the business cycle downturn.

Regardless of the ultimate resolution of that debate, I believe it would be a mistake for policymakers to evaluate future policy from that perspective. The U.S. economy *is* growing, albeit slowly, not declining. Gross Domestic Product (GDP) has been rising since the third quarter of 2009, and employment is up from its trough in December 2009. There is substantial and widespread evidence of an ongoing economic expansion. Accordingly, this is not the time for counter-cyclical "stimulus".

The pace of expansion remains solid and unspectacular. In many ways this is not surprising. As documented in Rogoff and Reinhart (2009), economic expansions in the aftermath of severe financial crises tend to be more modest and drawn out than recovery from a conventional recession.[1] Nevertheless, at this juncture it is imperative that policy be focused on generating the maximum possible pace of economic growth. More rapid growth is essential to the labor market futures of the millions of Americans without work. More rapid growth is essential to minimizing the difficulty of slowing the explosion of federal debt to a sustainable pace. More rapid growth will generate the resources needed to meet our obligation to provide a standard of living to the next generation that exceeds the one this generation inherited.

[1] See *This Time Is Different: Eight Centuries of Financial Folly*, by Carmen M. Reinhart and Kenneth Rogoff, 2009.

Drivers of Economic Growth

Policies focused on more rapid economic growth are the most important priority at this time. In light of this, it is useful to reflect on the four basic sources of growth in final demand for GDP: households, businesses, governments, and international partners.

Households are caught in a double bind of badly damaged balances sheets and weak income growth. As is well known, the collapse of the U.S. housing bubble left many households in mortgage distress, and more broadly diminished the net worth of the household sector. In addition, the financial crisis itself destroyed additional household wealth, with the result that household net worth is now $9 trillion below where it stood in 2007. The expansion thus far has yielded modest income growth.

It would be unrealistic, or even unwise, to expect households to be a robust source of final demand growth. Instead, the best course for households would be to repair their damaged balance sheets as quickly as possible. Policies that support the ability of households to do so while otherwise maintaining their consumption patterns will be the most beneficial. There is little that one-time "stimulus" in the form of tax cuts or transfers contribute to these goals.

Similarly, federal and sub-federal governments face enormous budgetary difficulties, largely due to long-term pension, health, and other spending promises coupled with recent programmatic expansions. Consider the federal budget. Over the next ten years, according to the Congressional Budget Office's (CBO's) analysis of the President's Budgetary Proposals for Fiscal Year 2011, the deficit will never fall below $700 billion. Ten years from now, in 2020, the deficit will be 5.6 percent of GDP, roughly $1.3 trillion, of which over $900 billion will be devoted to servicing debt on previous borrowing.

The budget outlook is not the result of a shortfall of revenues. The CBO projects that over the next decade the economy will fully recover and revenues in 2020 will be 19.6 percent of GDP – over $300 billion more than the historic norm of 18 percent. Instead, the problem is spending. Federal outlays in 2020 are expected to be 25.2 percent of GDP – about $1.2 trillion higher than the 20 percent that has been business as usual in the postwar era.

As a result of the spending binge, in 2020 public debt will have more than doubled from its 2008 level to 90 percent of GDP and will continue its upward trajectory. Traditionally, a debt-to-GDP ratio of 90 percent or more is associated with the risk of a sovereign debt crisis. Indeed, there are warning signs even before the debt rises to those levels.

The President released his budgetary proposals for Fiscal Year 2012 this past Monday. While CBO has yet to have the opportunity to provide a non-partisan look at their implications, my reading of the budget is that **[will complete here]**

The fiscal future outlined above represents a direct impediment to job creation and growth. The United States is courting downgrade as a sovereign borrower and a commensurate increase in borrowing costs. In a world characterized by financial market volatility stemming from Ireland, Greece, Portugal, and other locations this raises the possibility that the United States could find itself facing a financial crisis. Any sharp rise in interest rates would have dramatically negative economic impacts; even worse an actual liquidity panic would replicate (or worse) the experience of the fall of 2008.

Some suggest that we can stave off such a crisis by raising additional revenue. Ultimately, this approach is likely to fail as the potential spending plans exceed any reasonable ability for the U.S. to finance via higher taxes. No tax regime since World War II has come close to raising 25% of GDP, during a period that has seen an incredible variety of tax rates.

In short, the failure to control future spending raises the prospect of higher interest rates, higher taxes, or both. This constitutes a serious impediment to confidence The federal government needs to reduce spending growth, and control its debt. No sensible growth strategy can be built around greater federal spending, or greater government spending more generally.

With households and governments repairing balance sheets this leaves private-sector investment spending and net exports at the heart of badly-needed pro-growth policies. Policies to encourage more international trade are important and should be explored vigorously. The United States has been on the sidelines of international trade agreements for far too long. Pro-trade polices should be a bipartisan approach to raising growth and increasing jobs.

The Role of Housing Policy

This framework suggests two channels by which housing finance policy will affect the pace of economic growth: housing valuations and new construction incentives. Housing valuations are a central part of household asset holdings. Until housing valuations stabilize, households will continue to be under stress and restrict their spending. The most important objective at the moment is to clear excess housing inventory. To date, no federal housing policy has been successful in speeding this process; indeed most observers would argue that they have slowed this process. In sum, getting federal policy out of the way would be the best way to speed progress from this front.

Housing valuations also depend crucially on purchasers' expectations of future federal housing policies ranging from tax-deductibility of mortgage interest, to subsidies for energy-efficient investments to guarantees for the securitization of conforming mortgages. I will discuss my thoughts on housing policy below. Regardless, one lesson is that the sooner that policy is settled the better it will be for stabilizing housing valuations and removing the drag from the housing market from job creation and growth.

Similar considerations apply to the second channel by which housing affects macroeconomic growth: the construction of residential single- and multi-family homes. Incentives to build depend in the same way on the expectations for low-income tax credits and other federal policies. Resolving policy uncertainty will speed the ability of the construction sector to make decisions on demographic and economic fundamentals.

A Framework for Policy Towards Housing and Housing Finance

Housing is one of the most heavily regulated economic activities. However, the dominant federal policy interventions are those that provide subsidies to the debt-finance of the purchase of owner-occupied housing. The tax deduction for mortgage interest costs takes precisely this form. Similarly, taxpayer financed guarantees for mortgages through the Federal Housing Administration and the Government Sponsored Enterprises are subsidies to debt-financed homeownership.

It is evident from the recent housing bubble and current market conditions that this approach has not served market participants well. Thus, it is useful for the committee to step back and answer key questions regarding the policy framework toward U.S. housing:

- Should the federal government subsidize housing?
- If subsidies are appropriate, should they apply equally to rental housing and owner-occupied housing? Or, is it a policy objective to promote homeownership over rental occupancy?
- If subsidies are appropriate, should they be provided directly to owners and renters – i.e., through the purchasers of housing services? Or, is it more desirable to subsidize builders and sellers of apartments and houses in order to improve their affordability?
- Should subsidies depend on the mixture of debt and equity finance?
- Will subsidies be transparently displayed on the federal budget and controlled by Congress? Or, will the federal government continue to provide virtually open-ended mortgage subsidies through the tax code and off-the-books finance subsides via the GSEs?

Conclusion

Thank you for the chance to offer this brief written statement. I would be happy to elaborate in areas that you find interesting and look forward to answering your questions.

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U.S. HOUSE OF REPRESENTATIVES

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Douglas Holtz-Eakin	

3. Please list any offices or elected positions held and/or briefly describe your representational capacity with each of the entities you listed in response to question 2:

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4. Have <u>you</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2009, related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any federal grants or contracts (including any subgrants and subcontracts) since October 1, 2009, related to the subject on which you have been invited to testify?**
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