Testimony of Mark A. Calabria, Ph.D.

Director, Financial Regulation Studies, Cato Institute
Submitted to the
Subcommittee on Insurance, Housing, & Community Opportunity
House Committee on Financial Services
On "Legislative Proposals to End Taxpayer Funding for Ineffective Foreclosure Mitigation Programs"
March 2, 2011

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Chairman Biggert, Ranking Member Gutierrez, and distinguished members of the Subcommittee, I thank you for the invitation to submit testimony for today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a nonprofit, non-partisan public policy research institute located here in Washington, DC. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official policy positions of the Cato Institute. In addition, outside of my interest as a citizen, homeowner and taxpayer, I have no direct financial interest in the subject matter before the Committee today, nor do I represent any entities that do.

Deficits as far as the eye can see

The fiscal deficits facing our nation are simply without precedent. The Congressional Budget Office (CBO) projects a 2011 deficit of $1.48 trillion, almost 10 percent of GDP. While of course a considerable portion of this deficit is due to short term factors related to the recession and financial crisis, much is structural. Under current policy, CBO estimates that in 10 years, in 2021, our annual fiscal budget deficit will still be $763 billion. The 2021 projected deficit is also not from a lack of revenues, as revenues are projected to be 20.8 percent of GDP, above the historical average of around 18 percent and near what many economists consider the maximum amount that can be borne by the economy without substantially shrinking the economy (and hence actually lowering total dollar revenues).

Federal spending currently hovers around 20 percent of GDP, but is projected by CBO to reach 24 percent by 2010, a 20 percent increase in the size of government relative to GDP in just 10 years. This is likely an underestimate, as the CBO baseline assumes several policy outcomes, like sharp reductions in Medicare's payment rates for physicians' services, which may not come to pass. The drivers of this spending are Social Security, Medicare, Medicaid and other health entitlement programs. We cannot address our long term fiscal imbalances without reform of these programs. As defense spending also remains a considerable portion of the budget going forward, cuts to defense spending should be high on the list of any deficit reduction package.

Recognizing that the primary drivers of our long term fiscal deficits are outside the jurisdiction of the Financial Services Committee, I commend the Committee for

examining programs within its jurisdiction that can be eliminated or cut. I also commend the Committee for not waiting for these larger issues to be resolved. Although the current deficit is projected to decline as the economy strengthens, before rising again, efforts should be made to reduce the current size of the deficit, as such questions the credibility of political efforts to restrain future spending.

Where to Cut?

Spending cuts must start somewhere. Given concerns, which I believe are misplaced, that spending cuts could adversely slow the economy, a way to address such concerns is to target first those programs that are actually doing harm to the economy and slowing the pace of recovery. While well-intended, the various programs designed to keep delinquent borrowers in their current residence; I believe are slowing the needed, and inevitable, re-balancing of our housing and labor markets.

Jobs, Jobs, Jobs

There is perhaps no more important economic indicator than unemployment. The adverse impacts of long-term unemployment are well known, and need not be repeated here. Although there is considerable, if not complete, agreement among economists as to the adverse consequences of jobless; there is far less agreement as to the causes of the currently high level of unemployment. To simplify, the differing explanations, and resulting policy prescriptions, regarding the current level of unemployment fall into two categories: 1) unemployment as a result of lack of aggregate demand, and 2) unemployment as the result of structural factors, such as skills mismatch or perverse incentives facing the unemployed. As will be discussed below, I believe the current foreclosures mitigation programs have contributed to the elevated unemployment rate by reducing labor mobility. The current foreclosures mitigation programs have also helped keep housing prices above market-clearing levels, delaying a full correction in the housing market.

First we must recognize something unusual is taking place in our labor market. If the cause of unemployment was solely driven by a lack of demand, then the unemployment rate would be considerably lower. Both GDP and consumption, as measured by personal expenditures, have returned to and now exceed their pre-crisis levels. But employment has not. Quite simply, the "collapse" in demand is behind us and has been so for quite some time. What has occurred is that the historical relationship between GDP and employment (which economists call "Okun's Law) has broken down, questioning the ability of further increases in spending to reduce the unemployment rate. Also indicative of structural changes in the labor market is the breakdown in the "Beveridge curve" – that is the relationship between unemployment and job vacancies. Contrary to popular perception, job postings have been steadily increasing over the last year, but with little impact on the unemployment rate.

Historically many job openings have been filled by workers moving from areas of the country with little job creation to areas with greater job creation. American history has

often seen large migrations during times of economic distress. And while these moves have been painful and difficult for the families involved, these same moves have been essential for helping the economy recover. One of the more interesting facets of the recent recession has been a decline in mobility, particular among homeowners, rather than an increase. Between 2008 and 2009, the most recent Census data available, 12.5 percent of households moved, with only 1.6 moving across state lines. Corresponding figures for homeowners is 5.2 percent and 0.8 percent moving across state lines. This is considerably below interstate mobility trends witnessed during the housing boom. For instance from 2004 to 2005, 1.5% of homeowners moved across state lines, almost double the current percentage. Interestingly enough the overall mobility of renters has barely changed from the peak of the housing bubble to today. This trend is a reversal from that witnessed after the previous housing boom of the late 1980s burst. From the peak of the bubble in 1989 to the bottom of the market in 1994, the percentage of homeowners moving across state lines actually increased.

The preceding is not meant to suggest that all of the declines in labor mobility, or increase in unemployment, is due to the foreclosure mitigation programs. Far from it. Given the many factors at work, including the unsustainable rate of homeownership, going into the crisis, it is difficult, if not impossible, to estimate the exact contribution of the varying factors. We should, however, reject policies that encourage homeowners to remain in stagnant or declining labor markets. This is particularly important given the fact that unemployment is the primary driver of mortgage delinquency.

Ending the TARP

While there is widespread agreement that the TARP, as authorized under the Emergency Economic Stabilization Act of 2008, is one of the most controversial pieces of legislation passed in modern times; there remains considerable disagreement over its effectiveness. For those of us who believe the TARP was a mistake, it is time to finally put an end to the program. Fortunately many of the components of the TARP have already ended, and at less cost than may have originally been feared (although many at the time predicted "profits"). There remains approximately $60 billion in obligated but not expended TARP funds. The vast majority, $44.6 billion as of December 31, 2010, of unexpended TARP obligations are in the TARP housing programs. All of this funding should be rescinded.

Although the success of a government program should not be determined solely on whether or not it turns a "profit", the ultimately costs of the TARP will be almost exclusively the result of the auto bailouts and the housing programs. If Congress were to rescind the obligated, but not expended, housing funds remaining under the TARP, then the ultimately program costs are likely to be under $20 billion.

Banker bailout by another name

Over 60 percent of expenditures under the TARP housing programs have taken the form of "incentive payments". For instance loan servicers receive a one-time payment of $1,000 for each permanent modification under HAMP. Servicers also receive an

additional compensation amount of $500 if the borrower was current but at imminent risk of default before enrolling in the trial plan. Servicers can also receive payments of up to $1,000 annually for three years if the borrower remains current.

Borrowers also receive incentives of annual principal reductions of up to $1,000 annually for a maximum of five years. Interestingly enough, this “borrower” incentive is actually paid to the servicer. Investors, who are often the banks themselves, can also receive incentive payments in exchange for the lowering of monthly mortgage payments.

Almost $600 million has been paid to lenders and investors to modify loans. If these were indeed loans that would have otherwise defaulted, then lenders and investors stood to suffer significant losses. Repeated throughout the recession was the assertion that foreclosure was not in the lender’s interest. One cannot help but wonder why the American taxpayer has had to pay lenders and investors $600 million, so far, to do what was apparently already in their interest. The truth is that the TARP housing programs have largely been a transfer from the taxpayer to the very mortgage lenders that contributed to the financial crisis. If we are ever to reduce irresponsible lender behavior, then the place to start is to have the lenders bear the costs of their own mistakes, rather than the taxpayer.

Conclusion

The foreclosure mitigation efforts of both the Obama and Bush Administrations have largely been failures. Their one saving grace has been that such programs have been much smaller than originally projected. These programs have delayed the needed corrections in both our housing and labor markets, effectively prolonging weaknesses in the economy. The TARP housing programs have also represented the largest source of expected losses in the TARP. Ending these programs would immediately protect the taxpayer from future loss. Contrary to concerns about broader cuts to the federal government, eliminating the TARP housing programs would accelerate the recovery of our economy. Lastly, ending the TARP housing programs would put an end to what can only be characterized as back-door bank bailouts, for lenders have been the largest beneficiaries of these programs.