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Housing Subsidies and Other Similar Subsidies

I don't like subsidies, no matter whether to individuals, farms, or business firms; and I want to remove nearly all. Most individual people, other than business people, are alright with removing subsidies to business firms and farms but get angry over the ideas that "writing off" mortgage interest payments from their taxes is a subsidy and it should be removed. It is and it should be. This essay explains why. This essay does not use statistics, charts, graphs, or real data. I use only made-up simple cases to show basic ideas. In other essays, I will do the research pointed to in this essay. The ideas in this essay about subsidies for house buyers apply to nearly all other subsidies such as aid to farmers and tax breaks to business firms but I don't show how explicitly. I hope you will generalize to other cases.

The subsidy on houses causes more harm than good. It raises the price of houses and raises the interest rates on house loans and all loans. The original intents of the subsidy were to help people buy houses so they would be good citizens. In fact, the effects are: To help some people buy houses but to prevent other people from buying houses. The subsidy forces all people who are not buying a house to support people who are buying a house. The subsidy forces poor apartment dwellers to pay for the houses of richer people. The subsidy shifts a huge amount of money into financial institutions such as banks. We do not so much subsidize people who buy houses as we subsidize banks. People who cannot afford houses pay taxes so banks can make money from people who do buy houses. The whole economy is distorted, resulting in a smaller economy and fewer jobs. The best thing is remove the subsidy. If you want to buy a house, you have to deal with its real price and the real rate of interest. Both will be lower than they are now under a distorted subsidized market. Banks should have to make money the old fashioned way, not through subsidies from the state, but by making safe loans to honest hard working people. The same comments apply to nearly all other subsidies.

We need some facts about our economy and housing:

-To have more of one thing, we have to have less of another thing or other things. If you want a bigger car, you have to have a smaller TV and-or a smaller house, or you have to send your children to public school. If you want better food, you have to buy fewer CDs and books.

-"There is no free lunch". You can't get anything for free. Nobody can get anything for free. The state can neither get nor give anything for free. Everything has to be paid for one way or another. People recall this idea just fine when it comes to other people getting a benefit from the government (state) such as welfare (or free lunches for poor kids) but not when it comes to their own benefit from the state such as tuition help or reduced mortgage payments.

-In particular, the state has to meet its bills eventually. The state can only meet its bills through taxes. When the state reduces taxes on one group, it has to increase taxes on other groups to make up for the revenue. What the state gives away to house owners in a mortgage subsidy it has to collect from other taxpayers and-or it has to collect from house owners with other taxes.

-When the state gives something, that thing has to be paid for, including subsidies on house payments. This is another way of saying "there is no free lunch" but people still have the idea that the state can somehow create value out of thin air and give it to them in particular without affecting anyone else.

Now a little history and some facts about house prices, sizes, and locations:

-The size of an average house in the United States has about doubled since the 1950s from less than 1700 square feet to about 3000 square feet.

-The price of an average house has gone up faster than general inflation. Sometimes it has gone up much faster such as in the late 1960s to late 1970s and again in the 1990s.

-The price of an average house has gone up faster than the rise in incomes.

-Even adjusting for the increase in house size, the price of houses has gone up faster than incomes and faster than inflation.

-To compare the effects of house sizes, house prices, incomes, and inflation would require the use of statistics, so I don't do that here.

-The need for good schools has been a big factor in driving up the price of houses. People want a house in a good school district and will pay much more for that house in that district than for a similar house in a "bad" or mediocre district. The desire for a house in a good school district is not the only factor driving up house prices but it is a large factor.

-The push for houses in good districts has driven the general increase in house prices. It is not always clear how an increase in the price of some houses drives up the price of houses in general, and this effect doesn't always happen (you can buy a house in Gary, Indiana for $1). But overall it does happen, and it does happen enough to push up general prices.

-People have alternatives to large houses: smaller houses and apartments. They want big houses. The desire for large houses also drives up the price in general.

-The population of America in 1950 was about 150 million people. In 2015, the population is about 330 million people. That is a large increase, especially by the standards of developed countries. Most of the increase is in cities, where people also compete most strongly for schools. It is not clear how much the increase in population has affected house prices.

People want to live in houses for reasons other than school districts:

-Living in a house is a sign that you have “made it”.

-People think houses, and a neighborhood of houses, provide a better environment for raising children regardless of schools.

-People think good schools districts are more likely to be found in a neighborhood dominated by houses than one with many apartments.

-People feel they can better choose who they want to live with in a neighborhood of houses than in a neighborhood of apartments. People feel they can live with other people like them, in particular of the same socio-economic class, and often of the same ethnicity, religion, view on gender orientation, life style, or political party.

-People can have hobbies in houses that they can’t in apartments such as boats and motorcycles.

-People feel that stable neighborhoods based on houses are safer and cleaner.

The state (government) wants people to live in houses for the above reasons and for some reasons of its own:

-Neighborhoods of houses have lower crime and especially lower personal crime. They are cheaper to police.

-Neighborhoods of houses might have lower fire rates per building although it is not clear if they have lower fire rates per unit or per family. A fire in a house is not as likely to spread to other houses as a fire in one apartment is likely to spread to other apartments and other buildings.

-People who live in neighborhoods of houses usually stay for a long time and they get involved in local activities such as local sports and local churches.

-People in houses in neighborhoods usually are a better tax base for local schools.

-People in houses in neighborhoods vote more often and they tend not to vote radically whether they are mostly left or right.

-Americans have an idea of “house as castle” that is part of the feeling of being an American.

The central state (federal government) decided that house owners make better citizens, for all these reasons. Especially after World War Two with many returning veterans, the state devised several plans to help people buy houses and stay in houses. I do not distinguish between plans. I use “writing off your interest payments on your taxes” to stand for all the plans.

I love many of these reasons. I wish all school districts were good, and I wish every family could afford to buy a decent house in a good district using its own resources without help from the state. I also wish every American could get a good job. I wish we could have the good aspects of housing support and so gain the benefits of these reasons but not get hurt by the bad aspects.

Why subsidies for house buying are not good is best seen indirectly through a simplified example:

There are only three colors of cars: Red, White, and Blue. All three cars cost the same, $20,000. All three are otherwise identical. In effect, there is one kind of car that comes in only three colors.

The state decides it wants people to buy blue cars, so it decides to give each buyer of a blue car $5000. Now, in effect, the price of a blue car is $15,000 as long as the buyer gets all of the subsidy and the car dealer and the car finance company get none.

Of course, everybody will buy a blue car (big house) and nobody will buy a red car or white car (small houses). There is a rush to buy blue cars, and the dealers can’t keep enough in stock. White and red cars disappear from the market.

The dealers tell prospective buyers that the dealers can put them at the head of the line to get a new blue car if the buyer shares the subsidy with the dealer. In nasty terms, the dealer wants a kickback. The prospective buyers can always buy a red car or white car but they have to pay $5000 more for it, so they agree to kickback some to the dealer. How much?

A precise answer depends on ideas from economics that would clutter up this essay. A simple answer: As long as a buyer gets even $1 off the price of a blue car, he-she is better off agreeing along with the dealer, buying the blue car, and letting the dealer get most of the subsidy. Even if the car costs the buyer $19,999, and the dealer gets $4999, the buyer is better off taking the deal. In effect, the price of a blue car is now $25,000; the buyer gets a small amount; and the dealer gets a lot of extra profit.

In reality, the buyer and dealer likely would more nearly split the subsidy in a ratio of $2000 to buyer and $3000 to dealer. So, although the official price of the car is $20,000, the effective price of a blue car now is $25,000; the state pays $5000; the buyer pays $18,000 ($2000 from the state); and the dealer gets an extra $3000 in profit.

If the state "pokes its nose" into this arrangement and objects to the buyer "sharing" the subsidy, then the dealer only needs to raise the initial price from $20,000 to $24,000; the effective price remains $25,000. I do not guess how they split the subsidy in this case.

Pay attention to the price of the car. The price did not stay the same. The price went up by nearly the amount of the subsidy.

This outcome gets the attention of the bank. In the large majority of cases, without finance, no car can be bought or sold. So the bank tells the buyer and dealer that it wants in on the subsidy split. A likely outcome: the price of a blue car is $25,000; the state pays $5000; the buyer pays $19,000 ($100 from the state); the dealer gets an extra $1000 profit; and the bank gets an extra $3000 profit. The buyer is still wise (economically rational) to go along even though the effective subsidy for the buyer is now only $1000. This example does not take interest into account; it does not explain why the bank has to get involved; it only assumes the bank does have a say in what happens.

To see why the bank has a say, we have to consider loans and interest. Taking interest into account complicates issues. I have to simplify. Although the following is unrealistic in detail, it still conveys ideas accurately.

Start without the subsidy. Suppose a car costs $20,000, the rate of interest on a car loan is 6% (1.06), and the term of the loan is 5 years. Each year the car buyer pays one-fifth of $20,000 or $4000, plus the interest on what is still owed. The first year, the car buyer pays interest on $20,000; the second year, interest on $16,000; the third year, interest on $12,000; the fourth year, interest on $8000; the fifth year, interest on $4000; and, by the end of the fifth year, it is all paid off. How much does the car buyer pay in interest and how much in total? See the summary below:

Interest rate of 6% Starting price of $20,000 No subsidy Buyer pays all interest	Year 1	Year 2	Year 3	Year 4	Year 5	
Principle remaining	20,000	16,000	12,000	8000	4000	
Paid on Principle so far	4000	8000	12,000	16,000	20,000	
Interest this year	1200	960	720	480	240	
Total interest paid	1200	2160	2880	3360	3600	
Total paid so far	5200	10,160	14,880	19,360	23,600	

Now we have to think of what happens when the subsidy enters the picture. If the car dealer raises the price of the car much in the beginning, the state likely will object. So the car dealer and the bank want to share in the subsidy but not make the state angry. The car dealer can raise the price a bit and the bank can raise the rate of interest.

Interest rate of 8% Starting price of $22,000 Subsidy of $5000	Year 1	Year 2	Year 3	Year 4	Year 5	
Principle remaining	22,000	17,600	13,200	8800	4400	
Paid on Principle so far	4400	8800	13,200	17,600	22,000	
Interest this year	1760	1408	1056	704	352	
Total interest paid	1760	3168	4224	4928	5280	
Total paid so far	6160	11,968	17,424	22,528	27,280	
Less $5000 subsidy					22,280	

We are not comparing this case to the case without interest. We are comparing this case to the case with interest but no subsidy. Here, all the buyer wants is to use the subsidy of $5000 to pay less than the original-price-and-interest-before-subsidy of $23,600 ($20,000 sticker price plus $3600 interest) after all payments, including interest and subsidy, have been accounted for. Any combination of price, interest, and subsidy that allows the buyer to do this, the buyer calls a win. The seller raises the initial price by $2000 from $20,000 to $22,000, and the bank raises the interest rate from 6% to 8%.

Let's see what happens. The buyer pays a total of $27,280 ($22,000 principle and $5280 interest) and gets a subsidy of $5000, so the buyer pays $22,280 in total, less than $23,600. The buyer is happy. The seller gets $2000 by raising the sticker price, so the seller is happy. The bank gets $5280 in interest. $5280 in interest is more than the bank originally got in interest before the subsidy ($3600), so the bank is happy. The buyer pays $2000 more for the original price than if he-she had had paid for the car in cash in a market without subsidies. But nobody is unhappy.

A rise in the interest rate from 6% to 8% might not seem like a lot but it has significant effects. A rise from 6% to 8% is a rise in the interest rate of 25% (or 33%).

The only groups to have lost are: first, the people who had to pay for the subsidy, that is, all the people that didn't buy a blue car, that is, all the taxpayers. Second, from now on, all buyers, including cash buyers, have to work with a starting price of $22,000 because that is the new standard price in a market that has been distorted by subsidies. If a cash buyer does not want to pay this price, or insists on negotiating down too much, the seller prefers to go to a subsidized buyer instead. Also, third, if anyone had to buy a car using payments-with-interest but did not qualify for a subsidy, that person would have to pay a higher initial price than in a market without subsidies, and would be unhappy.

	Year 1	Year 2	Year 3	Year 4	Year 5	
Starting price $20,000						
Interest this year 6%	1200	960	720	480	240	
Total interest 6%	1200	2160	2880	3360	3600	
Starting price $22,000						
Interest this year 8%	1760	1408	1056	704	352	
Total interest 8%	1760	3168	4224	4928	5280	

The price of cars goes up. Car buyers do pay less in total than they would have paid for principle-and-interest without the subsidy but more than the original "real" price of the car in a market without subsidies ($20,000). But the buyers do not really reap the full benefits of the subsidy. After a while, buyers don't know they don't reap only a portion of the subsidy because the price of all cars has gone up and the buyer has no un-subsidized car to compare price to. If any red cars or white cars are still on the market, the buyer might try to think out a comparison, but that is unlikely.

It is worthwhile changing the word "car" to "house": The price of houses has gone up because of the tax write off subsidy. Buyers do not reap full benefits of the subsidy but they don't know it. They think they are getting a good deal because they can write off the interest on taxes. The sellers get a share of the subsidy and the finance companies (banks) get a share. To decide who gets what share would be too hard for here but it is highly unlikely the buyer gets the big share and it is certain the buyer does not get the full subsidy. The banks usually get the biggest share of any subsidies.

If we extend the period of payback, that is, pay back over more years, the buyer pays more interest in relation to principle, and the effects of raising the price and shifting the subsidy to the bank would be greater. If we arrange it so the buyer did not begin paying back any of the principle for the first few years, but do pay interest for the first few years, the effects also would be stronger. The two factors combine to make the effects stronger.

To really see the full effects of a subsidy, and how banks really get the biggest share of any subsidy, we should complicate this simple scenario by more years. Mortgages are typically from 15 years to 30 years with 25 years likely most common. Unlike as with the car scenario above, the buyer does not begin to pay off the principle until a few years into the mortgage, depending on how long the total period of the mortgage is and the specific terms. Interest over 25 years accumulates. Typically, total payments on a house over 25 years are at least double, sometimes triple, the initial price. The buyers, and the payers of subsidies, pay about half-again as much as the price of the house in interest. If the house originally cost $300,000, the total payments might be $750,000 over 25 years, of which $450,000 is interest. As a wild guess: Of the $450,000, maybe half, or $225,000 would be paid in a free market without a subsidy on that kind of transaction while about half, $225,000, results from the subsidy and would not be paid in a free market even on that transaction. The bank is entitled to some interest because the payments do take place over time - but not all of the $450,000. Taxpayers pay the bank a bonus of about $225,000 above what it would get in a free market so someone with a good income can buy a house. I strongly advise playing around with a mortgage calculator on the Internet; they are easy to find. They don't say how much the initial price and the total interest payments have been inflated by subsidy – you should try to guess.

All this is one reason why banks were so eager in the housing market from the Reagan years on through the Bush Two years, and why their eagerness led to the collapse of the housing market.

By hoping to help families to be better citizens and to raise better citizens, the state raises the price of all housing and it subsidizes banks. Economists know this effect is going on, and politicians know so too. But politicians cannot remove the subsidy for reasons that I don't need to go into.

Everybody else subsidizes the person who buys that house. All the people who do not buy the house pay 1.5 times the price of the house in interest so the house owner can buy the house. This might not mean much if there was only 1 house buyer in America and 100 million other families not buying a house, but, when 30 million families are buying houses, then 60 million or so other families are paying the price of that house in interest for the first family. Suppose everyone who was not buying a house lived in an apartment. Then, all apartment dwellers are paying for the people who were buying houses. Even when we take into account that many people already own a house and so are not actively buying a house, still, the people not buying a house are paying for the house of other people.

(Lenders can still make a lot of money, and still garner most of the subsidy for themselves, if they don't raise interest. The can still make money and garner the subsidy by lowering interest. The bank has to use a long period of time compared to what the borrower would use without a subsidy or at a higher interest rate, such as going from 10 years to 30 years. It helps if the buyer does not begin paying back the principle for a few years. All this banks have eagerly done. To be precise about when the rate goes up or down, how much the rate goes up or down, the period, and a comparison of what might happen without or without a subsidy, requires more detail than is possible in this essay. I still think both the starting price and the interest rate are higher than they would be without subsidies.)

(I am unhappy with the housing subsidy and with the behavior of banks leading up to the crash of 2007 but I should not take it out on banks. Borrowers were more at fault in that drama and they are more at fault in the continuing misuse of the housing subsidy. Mostly, banks are not doing anything wrong. On the whole, they do more good than harm. If we replaced all bankers with "average Joes and Janes", in a year or two, Joe and Jane would do exactly what professional bankers do in pursuit of profit. Banks are simply rational, and we need them to act that way. If we want banks to act for the national interest, then we have to set the stage, the institutions, so that banks help America when they pursue profit. This is a job for politicians and the people. We have not done it well. If we have not done it well, we have only ourselves to blame.)

What would happen if the subsidy were removed?

House prices would drop. House values would drop. I don't know for sure how much they would drop. As a guess, I would say at least 20%, likely more. People who bought a house at prices that are inflated because of the subsidy would be angry – but they have already benefitted greatly, they have no cause to complain, and we all have to make adjustments when we "get off the state teat" and begin working in the free market.

Interest rates on mortgages would fall. If the state did not subsidize interest rates, people would not be willing to pay interest rates as high, and banks could not charge interest rates as high. Again, I am not sure but guess that interest rates would fall about 2 percentage points depending on where they were when the subsidy were removed. If the mortgage rate was 6%, it might fall to 4%. If the interest rate was 10%, it might fall to 6%. If it was 4%, it might fall to 3%.

Now we have four factors:

-Lower initial price
-Lower interest rates
-The buyer pays all the interest instead of the state paying most
-The bank gets less overall even though the buyer pays all of what the bank gets

I don't know how these four factors play out interacting together. I don't know for sure if the final effect is that more houses sell and more people are house owners or if fewer houses sell and fewer people are house owners. Again as a strong guess, I think more houses would sell and more people would be house owners, over the long run.

There are other considerations.

-Banks would make less from house deals. House deals still would be very secure but would not make as much profit for banks. I don't know how banks would respond but it is not likely they would cut back on house loans much. Banks would cut back on risky loans only.

-With fewer risky loans, the housing market would be more secure.

-Taxpayers in general would have more money and would spend it in areas other than housing and other than to give it to banks. On the whole, the economy would perk up.

-House buyers might spend slightly more of their income on houses but not much more, and so would have slightly less to spend in other ways but not much less. I doubt the total end result from this effect by house buyers' spending would be much different for the economy as a whole than it is today.

-As a result of getting interest subsidies from house deals, banks had a large amount of capital to invest. In effect, the taxpayers subsidized bank capital accrual and lending. Without the subsidy, banks would have less to loan. Because housing would still be a safe investment, banks would loan almost as much as ever on houses. Banks would have less to loan in areas other than housing. Likely banks would cut down on risky loans such as for another strip mall, especially if those risky ventures also stopped being "write offs". Loans would be made more on merits and less on their use as "write offs" and "loopholes". I doubt that banks having less to loan as a result of not receiving state subsidies (for house loans) would affect the general economy much but it would affect the economy some. I am almost certain this effect would be more-than-countered by the effect of tax payers having more money from not paying the subsidy and giving money to the bank, so spending more in the general economy, and so increasing the general economy.

-The rapid price increases in house prices since the early 1970s would slow down. When people have to pay their own interest, they are not as likely to accept a 10% increase in base price that results in paying 30% more overall. People will accept increases only about in line with a general increase in productivity for the economy as a whole (that is, an increase in salaries) and maybe in line with inflation. Because people will not accept continuous large increases, houses will no longer be as attractive for "flipping". Flipping in itself was one large reason for price increases, that is, increases allowed flipping and flipping causes increases. With this self-reinforcing link broken, the overall chain of price increasing will be weaker. Because house prices increase for reasons other than flipping and gullibility, such as the need for good school districts and the growth in population, house prices will still increase, but not nearly as much.

-General inflation, deficit spending, increase in education costs, increase in medical care costs, increase in transportation costs, and increase in housing costs, all tie together. It is not clear how much one drives the others. So I cannot say that decreasing the price of houses and stopping the rapid price increases of houses would, by itself, stop inflation. As long as we have deficit spending and the other causes, stopping the increase in housing costs by itself cannot stop inflation. But it would help – a lot. People have more invested in houses than in any other one single thing unless they are in the middle of a medical catastrophe or unless education costs have now outmatched housing costs. So, greatly reducing this one (biggest) factor would help with inflation.

In the past, people bought houses as a buffer against inflation because housing prices had always risen faster than inflation. With the housing subsidy removed, and with inflation reduced and house prices not rising as fast as before, people would be less tempted to invest in houses, and to pay a high price and high interest rates, as a buffer against inflation. If people are not buying houses as a buffer against inflation, then house prices will not increase as fast, and increased house prices will not contribute to inflation. Inflation will slow down. With inflation slowed down, people will not need to think as much about increasing the price of their house to outrun inflation. Reducing house prices starts a feedback loop that reduces inflation and house prices even more. This loop can't run forever and it can't reduce house prices to 1950 levels, but it would be noticeable and good.

-Houses would be a better investment for the average person-and-or-family. Houses would be homes again. They would not be something you invested in to hedge against inflation or invested in for much of any reason other than to live in. Because the market would be more secure and steady, we would not have the catastrophe of 2007. Because prices would not rise rapidly and the market would be more secure, if people had to sell a house, or wanted to sell a house, people could always sell a house at a stable price in a modest time. Houses would be like quality gem stones that people enjoy while they have and can sell if they have to.

There are two big things we can do to make the housing market more sensible and to allow less-than-rich people to own houses. The first is to eliminate the subsidy. The second is to make every single local school in America decent. Not every local school has to be a prep school for the Ivy League but every local school can graduate most of its students and every local school can make sure that every graduate has a decent character and knows what he-she is supposed to know. The fight between parents to get in a good school district likely is the single biggest force in increasing house prices. So, if we took away the fight for good schools by making sure all schools were good enough, we would take away the single biggest factor in housing price increase, and prices would not increase nearly as fast.

The remainder of this essay is optional. It is written to fend off some criticism and confusion.

The housing subsidy can work if the following conditions hold well enough, and only that way. These conditions never hold nearly well enough. There is nothing realistic we can do to make the conditions hold well enough.

I think the original framers of the subsidy (original congress people) thought these conditions would hold well enough. They did not foresee what would happen to the housing subsidy. Why experienced legislators and business people did not foresee that the housing subsidy would not work as it should and that it would have bad effects, I don't comment on.

-The entire population of the United States lives in houses.

-Nobody rents a house or an apartment. There are no apartments.

-The entire population can be divided into (1) those people who are buying a house now and (2) those people who already own the house "free and clear" and so are not buying a house.

-Everybody who is now buying a house will someday own the house "free and clear" and will be a house owner.

-All people who are buying a house receive a subsidy.

-All people who already own a house pay the subsidy for current house buyers.

-When the current generation of house buyers owns their houses “free and clear” already, three things will have happened:

=The older generation of house owners will have died off. Their houses get sold.

=Another younger generation of house buyers will have arisen. They buy the houses of the generation of house owners that has died off.

=The previous generation of house buyers becomes the current generation of house owners. The new generation of house owners stands in the same relation to the new generation of house buyers as the older generation of house owners stood to them when they were house buyers.

>The process of substitution and recruitment doesn’t have to happen in big generational lumps. It can be ongoing in lots of particular cases. At any one time, some people will be buying a house and getting a subsidy while other people will be living in a paid house and paying taxes. It is easier when first thinking about the idea to think of a whole second group (young people buying houses) replacing a whole first group (those who own their houses “free and clear”) while, at the same time, a third group replaces the second.

-Everyone who receives a subsidy now will give a subsidy later.

-Everyone who gives a subsidy now received one when he-she was younger.

-The older generation is taxed to help the younger generation buy a house. The older generation transfers buying power to the younger generation. The older generation is taxed as a way to transfer buying power to the younger generation. The older generation is willing to do this now because, in their time as the younger generation, they got help from their older generation. And so on.

-The banks serve as the conduit (vehicle, method) for the help from the older generation to the younger generation.

-ALL the money that the banks receive from the older generation to help the younger generation goes to buying houses. NONE of the money is diverted to any other purpose such as strip malls, casinos, church building, private rockets, car companies, dams, roads, welfare, corporate welfare, etc.

-Of course, the banks can receive a modest fee for acting as the conduit of buying power from the older generation to the younger generation.

I leave you to figure out what all there is about America now so this ideal is not met. You can begin with the fact that we have a huge population of renters, and the renter population is increasing. I leave you to figure out what there is about the real world so this ideal can never be met well enough.