A Dose of Urgency for Home Buyers is the Medicine Our Bipolar Economy Needs

Edward E. Leamer
Director, UCLA Anderson Forecast
Professor of Management, Economics and Statistics
UCLA

REVISED April 7, 2008

When it comes to homes, we suffer from a collective bi-polar disease, swinging from manic buying to depressed waiting. We are currently two years into the waiting stage of this disease, and we are experiencing a depressive episode that will soon be the longest and most severe since the Great Depression, with no end in sight. Though this disease is concentrated in the housing sector, it has almost always infected the rest of the economy, and led into national downturns with massive layoffs in manufacturing as well as construction.

The treatment for this disease is not a rescue package for current home owners, or a general tax rebate to stimulate spending. What we need is a dose of urgency in the form of a temporary tax rebate for first-time home buyers.

In our manic moods, frantic buying drives home prices to unaffordable levels, and one cure for the subsequent depression is a reduction in prices that is great enough to bring buyers back. While lower prices are part of the solution, they are also part of the problem. Our much-touted free-market system relies fundamentally on what economists call “downward sloping” demand curves: if the market price falls, sales rise. For homes that is not always the case. Lower prices are now creating the hope and expectation of still lower prices later, and buyers are choosing to wait it out to get the best deal. Thus lower prices create lower sales. This is a market pathology that causes unemployment and underemployment of homes first, and then workers.

The market experiences the flip-side pathology during the manic phase. Price increases, rather than reducing sales, create the fear and expectation of still higher prices to come, and buyers rush to get homes before it is too late. This is the key to designing the medicine we need now: a well-timed dose of urgency.

Most of us are frightened silly by the decision to buy a new home even in the best of times, and it takes some urgency to overcome the fear. The housing market is now utterly lacking urgency. The Federal government could administer a dose of urgency with a temporary tax rebate of 5% of the purchase price up to $25,000 for first-time home buyers. To create the urgency, it has to be temporary. Buy it now, or you don’t get it.

Alternatively, the Federal Reserve could control the manias by raising interest rates to limit excessive price appreciation and overbuilding. If the Fed successfully eliminated the housing manias, the housing depressions would disappear as well. But the Fed chose
very low interest rates in 2002-2004, just when the housing market needed some cooling off. Now the Fed is impotent to alleviate the depression because no level of interest rates is going to bring buyers back to a market with declining home prices.

A temporary tax rebate for first-time home buyers is an appealing solution. This rebate directly targets a worthy group: middle class families who thought they were priced out of the market forever, and young people who will benefit from getting a home sooner rather than later. It doesn’t bail out speculators in houses or in mortgages. But by creating demand for homes, this temporary tax rebate does cushion the fall for all the players, and helps every American by stimulating economic growth.

A temporary tax rebate needs to be carefully timed. If the rebate is offered too early, it will only delay the depression. If the rebate is offered too late, we risk creating another short-lived mania.

Last the really good news. There is no real cost for this program. It just puts happy and deserving American families into homes that would otherwise sit empty waiting for buyers. And financially, there might be no cost to the Treasury. This tax rebate is likely to stimulate enough economic growth to pay back the Treasury with higher revenues soon enough. After all, there is a lot of collateral spending surrounding the purchase of a home. The other tax reductions of which I am aware cannot come close to this level of stimulus.