Insight

Mortgages and eminent domain: May they never meet

DOUGLAS HOLTZ-EAKIN | AUGUST 9, 2012

The quality of housing policy ideas has crashed more than the market itself. Recently, the venture capital firm Mortgage Resolution Partners hatched the idea of using eminent domain to seize mortgages on behalf of borrowers as a way of assisting California's troubled property values whilst turning a profit. Since San Bernardino County first floated the proposal, Mayor Rahm Emanuel and two Chicago aldermen have shown interest in it, too, despite the raised eyebrows of officials at the Treasury and the Federal Housing Finance Agency.

Recall that eminent domain has been traditionally used in the case of public works projects — think highways and utility lines — and involves buying out property owners who stand in the path of progress. The key to these cases is that there is a larger public purpose and that our Constitution requires that property owners be compensated fairly for their losses.

Where is the public purpose in this? The power grab smacks of the worst kind of "crony capitalism," using the power of government for private enrichment. In this case, the government would step in to violate a valid contract (a mortgage), impose losses on one private party (investors, like pension funds) to benefit other private parties (venture capitalists and borrowers). But for one to gain, another has to lose. There is no free lunch — and no public policy achievement.

Instead, there could be broad public distress. Indeed, a worst-case scenario would be to crater mortgage investment markets going forward. As Fitch estimated, the California plan alone could put $7 billion of funding for mortgages at risk of seizure. Who invests in mortgage-backed loans? Primarily pension and mutual funds. 401(k) plans across America would suffer that $7 billion hit.

The second aspect concerns appropriate compensation. The math of this scheme would seem to work only if the cities first manage to choose borrowers on the verge of default. It would next have to underpay — not fairly compensate — the original lenders, and finally overcharge the new crop of hapless investors. As you can imagine, there would be very powerful incentives to seize private property at less than fair market compensation in order to flip the loans for a profit.

When investors reflect on the incentives, which of them would be willing to buy the repackaged defunct loans? Investors would either stay away in droves, or demand such a high premium to guard against seizures in the future that it would only serve to make mortgage credit dramatically more expensive, and much harder to come by. On top of that, the immense pricing problems make it likely that unfair compensation claims could clog up courts for years.

In the end, this approach will be defended as being in the public interest because it is a route to stabilizing housing markets. But this misses the larger point. Foreclosures are fundamentally an issue of the borrowers not being able to make the payments on the loans they originally took out. Unemployment and lack of income to support loan payments are likely the biggest factors in that unfortunate outcome. The solution to that is better growth; not delay tactics. The latter just extend the time before borrowers move to a more sustainable situation, homes are resold to willing and able buyers, and our housing markets heal.

The bottom line is that there is no magic wand, and no free lunch to the nation's housing and economic woes. The only option is good policies that foster growth and job creation — lower taxes, fewer regulations, reduced government debt. In the meantime, let's not dip into the Pandora's box of eminent domain and make things worse.

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