By Bill Spitz, Principal

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There's No Place Like Home - Or Is There?

The Affordable Housing Crisis Grows While Efforts to Increase Supply Fall Short

U.S. Government Accountability Office, Oct. 2023

There's Never Been a Worse Time to Buy Instead of Rent

WSJ, Oct. 2023

Home equity has been a key component of the net worth of American families for decades and home ownership has provided the opportunity for many to rise to the middle class or beyond. Yet, as per the headlines above, there currently is a housing crisis in the U.S. that makes it exceedingly difficult for young people to join the ranks of homeowners, and it also reduces worker mobility which hampers economic growth. I have written a number of blogs on various aspects of our housing problem, but this topic deserves a more comprehensive review. I cover the history of housing in the U.S. which provides context for an examination of the current situation. Both the dimension and causes of the crisis are explored in considerable detail and one key takeaway is that there are both economic and public policy issues at work.

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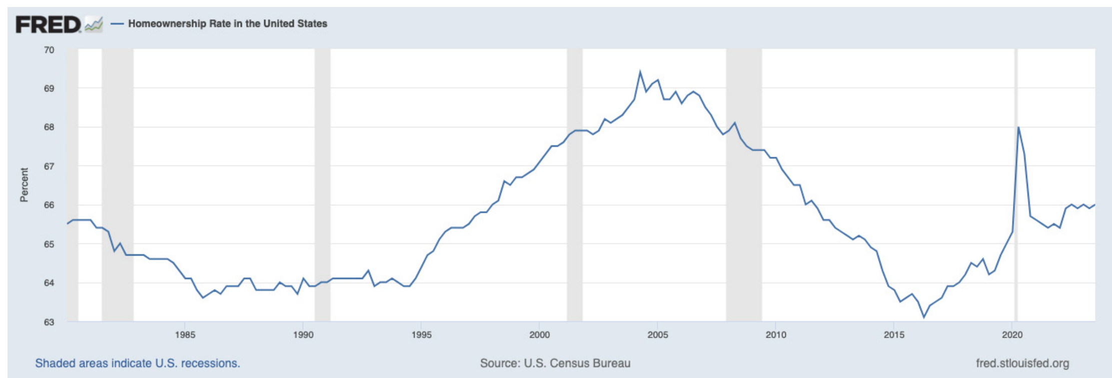
HOME OWNERSHIP

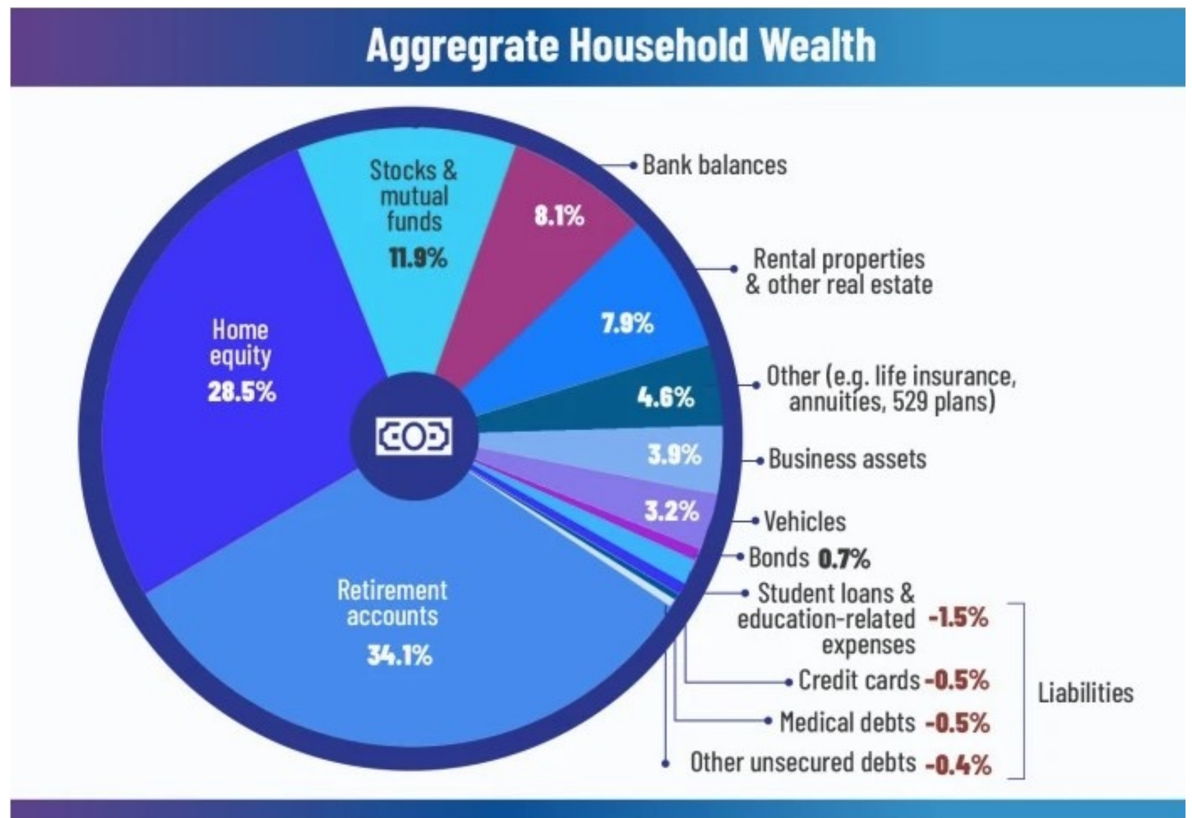
Until the 1940's, the percentage of Americans owning their home fluctuated between 43% and 48%. Remarkably, the homeownership rate rose to 62% by 1960 due to a combination of factors including rising incomes, the Baby Boom, the GI Bill of Rights, expansion of mortgage financing, the development of large scale subdivisions, and improving transportation. As shown in the chart below, homeownership was then rangebound between 63% and 66% from the early 1960's until 1995 when it began a surge to more than 69%. The increase from 1995 to 2006 is explained by demographic factors, legislation aimed at making ownership more available to lower income and minority groups, and innovations in mortgage finance including the development of subprime mortgages that turned out to be a major factor in the 2008 housing crisis. In the aftermath of that crisis, ownership fell back to 63% as lenders tightened their standards only to surge again during the Covid-19 pandemic when urban apartment dwellers fled to the suburbs and beyond. Despite a good deal of volatility, the most recent reading of 66% is right on the long term average.



Home ownership has been very good to most Americans. According to Nobel Prize winner Robert Shiller, home prices have increased at an average annual rate of 4.4% since 1987. The Federal Reserve maintains a median sales price series dating back to 1963 that shows average annual appreciation of 5.4%. To demonstrate the power of 4.5-5.5% annual price increases, assume the purchase of an "average" house in 1993 with 20% down and a thirty year fixed rate mortgage. Today, the mortgage would be paid off and the owner's equity would have multiplied by 16.5 times!

The importance of homeownership to individual Americans is powerfully demonstrated by the next chart which divides household assets and liabilities into various categories. Note that home equity is the second largest asset at 28.5%. Interestingly, you would think that the value of homes would be a much smaller percentage of total wealth for those at

the top of the economic pyramid since they would have large portfolios of stocks, bonds, and other assets. In fact, a study by Visual Capitalist found that 32% of the total wealth of this group consists of primary and secondary homes; not dissimilar to the statistic shown below for the average family.



Aggregate household wealth decomposed by asset type. Note: Some categories were combined for simplicity. U.S. Census Bureau

Highly leveraged or speculative home buyers discovered to their chagrin in 2007 that home prices do occasionally decline although the decreases are generally modest as compared to those experienced by stocks and other asset categories. The one exception to "modest" price decreases was the 2007-2012 period when the FED Median Sales Price Index fell 19% while the Case-Shiller Index declined 26%. To place those declines in perspective, the U.S. stock market fell 50% from peak to trough.

In terms of actual bricks and mortar, there are approximately 129 million housing units in the U.S. of which 82 million are individual residences and the remainder multi-family. One apparent contradiction is that the size of the average family decreased from 3.7 to 2.5 between 1940 and 2022 while the size of the average home has increased by 20% since 1990.

This disconnect is attributable to rising incomes, a significant increase in the number of young adults living with their parents, and the large increase since 2020 in those working from home.

At a higher level, residential construction is a very important component of the national economy representing 3-5% of GDP. That number increases to 15-18% of GDP when other housing related expenditures are included. According to the National Association of Homebuilders, roughly 8.6 million people are directly involved in residential construction and for every 100 construction workers, there are roughly 225 indirect or supporting jobs. Housing is also very important to the capital markets in that total mortgage debt outstanding is about $13.7 trillion of which roughly 65% is securitized. And, securitized mortgage debt represents 23% of the entire U.S. bond market.

With all of this as background, let's turn to the dimensions of the housing crisis.

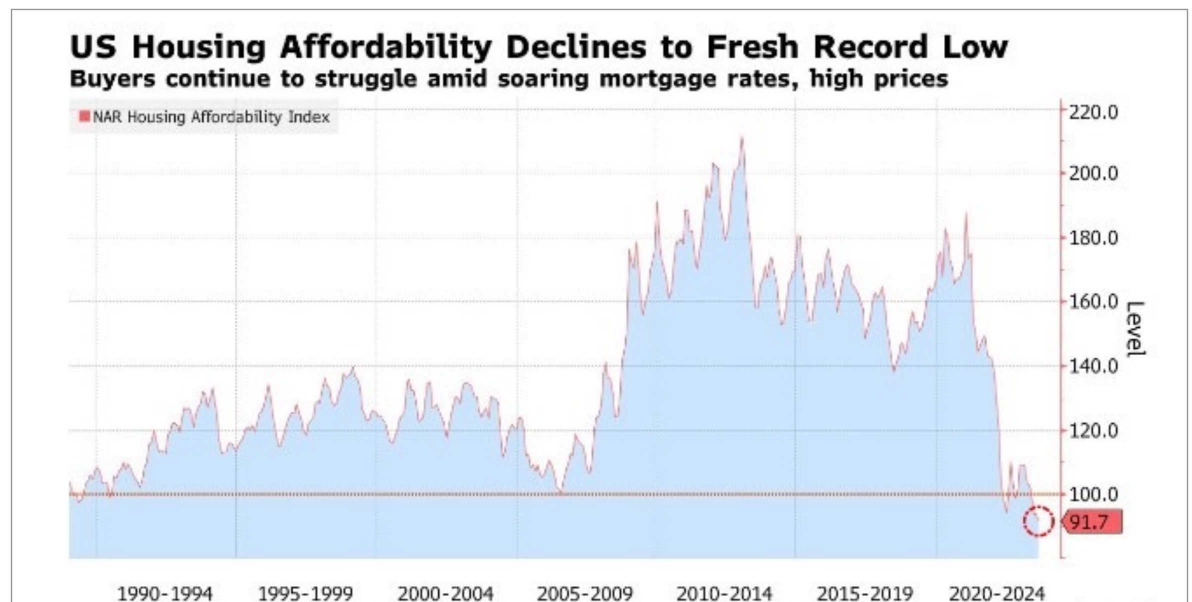
THE AFFORDABILITY PROBLEM

In the years since the onset of the pandemic, the median home price has risen from $322,600 to $431,000, an increase of 33.6%. At the same time, the average interest rate on a 30 year fixed rate mortgage rose from 3.23% to 7.60%. Combining the two, the 20% down payment typically required increased from $64,500 to $86,200 and the monthly mortgage payment exploded from $1,120 to $2,434, an incredible 117%. This painful trend is further illustrated by the following chart that shows the cost of buying versus renting.

Source: CBRE Research, CBRE Econometric Advisors, Freddie Mac, U.S. Census Bureau, Realtor.com®, FHFA

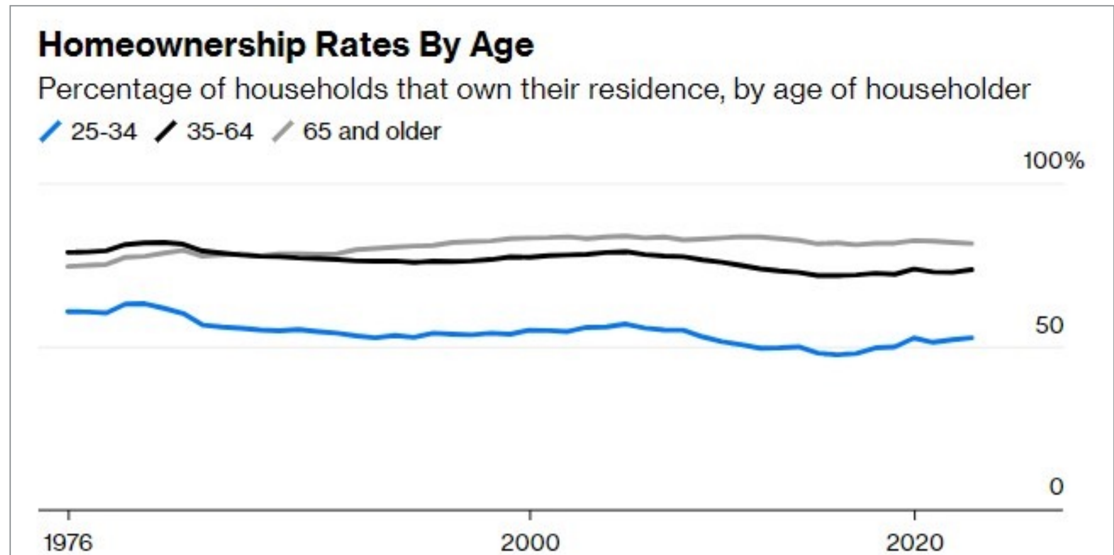
Note that the cost of buying is at an all-time high and is 52% greater than the cost of renting. As a result of this premium, many are either discouraged from looking for a home or simply frozen out of the market. The following affordability chart, which is provided by the National Association of Realtors, examines the cost of housing in the context of income. Note that the current affordability reading of 91.7 is the lowest since 1989. Any index figure below 100 indicates that someone with the median income cannot afford to purchase the median home. In fact, as many as 70% of Americans cannot afford the average home and the average person needs about a 50% jump in income to get there.

What are the actual income requirements? Redfin recently reported that income of $114,000 is necessary to afford the typical American home, an increase of 50% since August of 2019. As a basis for comparison, median household income in 2022 was roughly $75,000. Even more extreme than the national averages are California cities San Francisco and San Jose where the required annual incomes are $404,000 and $402,000, respectively. While not as severe, income requirements are also quite high in other California cities as well as in Seattle, New York, Boston, and Honolulu.



Source: National Association of Realtors. Note: 100 = median income can buy median-priced home

As stated at the outset, the affordability crisis particularly impacts younger Americans as illustrated by the following chart that shows home ownership by age bracket.



Source: Current Population Survey Annual Social and Economic Supplement microdata accessed via IPUMS-CPS, University of Minnesota, www.ipums.org

Since 1976, ownership in the 65+ age segment has actually increased from 74.5% to 81.5%. In contrast, the ownership rate declined from 78.8% to 73.5% for those aged 35-64 and from 60.7% to 52.7% in the 25-34 age group. Note that the percentage decline for the 25-34 segment was roughly twice that of the 35-64 cohort indicating that Millennials have been particularly hard hit.

THE NATURE OF THE PROBLEM

Given the historically high cost of home ownership, basic economics would lead us to expect a decrease in demand and a significant pullback in prices. At least so far, that has not happened. The Shiller Price Index is up 5.8% through August and it exceeds the July 2022 peak after declining slightly in the latter part of 2022 and early 2023. So, what is going on? The answer is that the supply of homes is severely constrained. The inventory of unsold homes currently sits at 3.4 months whereas 5-6 months is generally considered to be the level at which the market is in equilibrium. Time on the market is 48 days as compared to a longer term average of 57 days. Most important, the National Association of Realtors estimates that there is a shortage of roughly 6.5 million units. To place that number in perspective, there are currently about 1.6 million units under construction suggesting that this is a multi-year problem.

WHY IS THERE A SHORTAGE?

I will begin with the usual economist's qualification-it is complicated! First, let's tackle the economic issues and then turn to public policy considerations.

- The construction industry has a shortfall of approximately 650,000 workers. Wages in this sector have increased dramatically but strong demand for workers in other sectors presents significant competition given the difficult and occasionally dangerous nature of this work. One answer could involve allowing more immigration but that solution is obviously a political hot potato.
- Approximately 13% of homes are purchased by institutional investors for the single family rental market thereby removing them from the pool available to individual buyers.
- The severe trauma of the 2008 Financial Crisis weighs heavily on some developers rendering them permanently cautious or even unwilling to take on large projects. Despite having recovered somewhat from the 2010 trough, housing starts are still more than 40% below the 2006 peak.
- Just as high interest rates impact buyers, they change the economics of construction for homebuilders thus limiting production.
- Similarly, the prices of inputs to residential construction (Lumber, concrete, electrical equipment, etc.) are up 36% since January of 2020. Once again, this bout of inflation may decrease the activity level of homebuilders.
- Another major factor is what is known as the "lock-in" effect. About 61% of outstanding mortgages have an interest rate below 4%, and 23% are below 3%. Given new mortgage rates of approximately 7.5%, many homeowners find it uneconomic to relocate. They are effectively "locked-in" which reduces the supply of homes available to potential buyers.
- A key factor in the current supply-demand imbalance is what was likely a temporary acceleration in new household formation. This is a complex topic that probably merits its own white paper. However, the basic story is that rising incomes, improved employment prospects, and other factors resulted in Millennials forming new households in 2020 and 2021 at six times the rate that prevailed in the previous decade. This pressure should ease in the future but will require several years to normalize.

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REGULATION

It will come as no surprise that the role of regulation in the housing market is the subject of considerable debate. Of course, most people value regulations that require sound construction, promote safety, and protect the investment of the homeowner. However, detractors believe there are a number of regulatory barriers that unnecessarily reduce the supply of housing. They cite:

- Building code overreach-Some building codes require construction techniques and materials that exceed normal health and safety requirements. These regulations may be the result in some cases of lobbying by building materials companies. Burdensome codes raise the price of housing thereby excluding low to moderate income families. Finally, codes vary considerably from one jurisdiction to another creating complexity.
- Impact fees that disproportionately raise the price of housing.
- Environmental regulations that limit development and require expensive environmental impact studies.
- Slow moving, often duplicative, governmental agencies that create backlogs leading to construction delays.

A recent study found that differing regulation accounted for 40% of the variation in housing prices across various metropolitan areas.

NIMBY (NOT IN MY BACKYARD)

By far, the most controversial aspect of regulation is land use and zoning laws that were originally enacted in the early 1900's to protect homeowners by ensuring that industrial and other distasteful uses did not abut residential neighborhoods. Today, single family zoning is the most common restriction and roughly 75% of the land zoned for housing in American cities is subject to this limitation. Over the years, additional regulations have been promulgated that require minimum lot sizes, setbacks, and parking requirements, among others. Critics argue that all of these requirements have a number of detrimental impacts including:

- Creating housing shortages given that duplexes, and other multi-family developments are prohibited in many desirable locations.
- Higher home prices. A 2021 study estimates that onerous San Francisco regulations inflate home prices there by an average of $400,000 per unit.

- Racial discrimination.
- Limitation on upward mobility given that lower income individuals are unable to afford homes in areas with strong school systems.
- Economic inefficiency and lost productivity owing to the fact that many workers cannot afford to live in close proximity to their jobs.

Potential solutions are of course highly controversial often stimulating intense opposition. A number of cities have reformed single family zoning laws and five states have eliminated them statewide. However, similar attempts have been abandoned in several states including Connecticut and Arizona in the face of intense blowback. Other contentious proposals include rent control, laws requiring developers to include low cost housing as a component of developments, reduction in minimum lot size and setbacks, development of public transportation and elimination of parking requirements, changes in historical preservation laws, and easing of environmental reviews. Most controversial of all are proposals to give states and even the Federal Government preemptive rights over local zoning laws.

A GLIMMER AT THE END OF THE TUNNEL?

Some of the factors leading to the housing crunch are easing. Mortgage rates have dropped about .4% from their high, inflation in building costs seems to be moderating, there is evidence of softness in home prices in some markets, and the rate of new household formation should subside. However, it will take a number of years for the situation to stabilize because we will likely continue to experience labor shortages and the regulatory morass is certainly problematic. So, this is likely to be an enduring problem but we can still encourage our elected leaders to seriously explore thoughtful long-term solutions.

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