Cato Handbook for Policymakers

CATO INSTITUTE

7TH EDITION

22. Housing Policy

Congress should

- turn Fannie Mae and Freddie Mac into fully private organizations, subject to scrutiny by the Securities and Exchange Commission, as it did for Sallie Mae in 1995; and
- reject any proposals to give the Department of Housing and Urban Development, the Environmental Protection Agency, or other agencies regulatory authority over land use in order to promote environmental or other social goals.

State legislators should

- repeal any growth-management laws or other legislation, and refrain from passing new legislation, that give cities authority over land uses of rural areas.

The Real Cause of the Housing Bubble

Deflation of the recent housing bubble has produced the nation's worst recession in more than 25 years and economic repercussions throughout the world. To minimize the damage done by this housing bubble, and to prevent even worse housing bubbles in the future, it is important to understand the true causes of the bubble.

The steep rise in housing prices between 2000 and 2006 has been blamed on the Federal Reserve Bank, unscrupulous lenders, housing speculators, and the repeal of the Glass-Steagall Act. However, none of these factors explains why the growth in housing prices was so different from one region to another.

According to data published by the Office of Federal Housing Enterprise Oversight, housing prices in California and Florida grew by more than

140 percent from the first quarter of 2000. In Georgia and Texas, prices grew by only 45 to 47 percent. From the peak of the market, prices in California and Florida have dropped by an average of 13 to 18 percent. Prices in Georgia and Texas have not declined at all. Since Federal Reserve policies and the other factors listed earlier apply equally to all the states, some other explanation must be found for why housing in California and Florida bubbled whereas housing in Georgia and Texas did not.

The explanation is not that demand for housing is greater in California and Florida. With regard to sheer numbers, Atlanta, Dallas–Ft. Worth, and Houston are the fastest-growing metropolitan areas in the United States, yet they did not experience bubbles after 2000 and have not experienced price declines since 2006.

Instead, the answer is on the supply side of the housing equation. In a free market, the home construction industry can easily meet the demand for new housing resulting from rapid population growth, looser credit, or other changes in the market. If new housing remains affordable, existing home resales will remain affordable as well. If housing prices are not rapidly increasing, then speculators will not be attracted to the housing market.

In most of the regions suffering housing bubbles, the main factors limiting homebuilders' abilities to meet demand for new homes are a variety of land-use regulations that are collectively known as ''growth management.'' Growth management may include urban-growth or urban-service boundaries, large-lot zoning or other restrictions on development of land outside those boundaries, growth limits or growth caps inside the boundaries, and *concurrency* or *adequate public facilities* requirements that limit permits on new development until government financing is available to provide services to those developments.

The key to keeping housing affordable is the presence of large amounts of relatively unregulated vacant land. Historically, city zoning stopped at the city limits. City officials knew that if they imposed too much land-use regulation in the city, developers would go outside the city limits. To prevent this loss of tax revenue, cities kept their regulations flexible. This often led to charges that developers controlled city planning, but because developers would only build what buyers wanted, the truth was that consumers controlled city planning.

Growth-management and other laws that give cities control over rural areas changed the balance of power between consumers and city officials. Officials preferred that all development (and the resulting tax revenues) took place within city boundaries, so they eagerly used growth boundaries and other controls to limit rural development. This resulted in artificial land shortages and dramatic increases in housing costs.

Growth management comes in several flavors, including *slow growth*, which limits the number of building permits issued each year, and *smart growth*, which does not attempt to control growth rates but mandates that growth take place at higher densities instead of in the form of low-density ‘‘sprawl.’’ Both kinds of growth management make housing less affordable by creating artificial land shortages.

Hawaii passed the nation’s first statewide growth-management law in 1961. Oregon followed in 1973. In addition, California passed a law in 1963 that, while not intended as growth management, effectively gave cities control of all rural areas.

These laws quickly led to housing’s becoming unaffordable. A standard measure of housing affordability is the median home price divided by the median family income. A price-to-income ratio of 2 allows a family dedicating 25 percent of its income to a 6 percent mortgage to pay off that mortgage in just 11 years. Twenty-one years are required at a price-to-income ratio of 3, and 53 years at 4.

In the absence of government restrictions on homebuilding, the ‘‘natural’’ price-to-income ratio seems to be about 2. In 1969, price-to-income ratios throughout the United States were about 2—except in Hawaii, where they were 3. By 1979, Hawaiian ratios were well above 5, California’s were between 3 and 5, and Oregon’s were around 3.

Harvard economist Edward Glaeser notes that housing supply restrictions make prices not only higher but also more volatile. California prices, for example, declined by 10 to 20 percent in the early 1980s. Prices there bubbled again in the late 1980s, then deflated another 20 to 25 percent in the early 1990s. Glaeser also estimates that prices lose only about a third of the gains they make during each bubble, so they get more out of line with the ‘‘natural’’ price-to-income ratio of 2 with each successive bubble.

Few people noted the relationship between growth management and housing affordability problems, so several more states passed growth-management laws in the 1980s and 1990s, including Florida, New Jersey, Connecticut, Rhode Island, Maryland, Washington, Arizona, and Tennessee. In addition, several New England states, including Massachusetts, effectively gave cities control over rural areas by abandoning the county form of government. Finally, a few metropolitan planning organizations, including those for Denver and the Twin Cities, began practicing growth management without the benefit of state legislation.

In almost every case, these laws and plans led to housing bubbles that reduced housing affordability. By 2006, price-to-income ratios ranged between 8 and 12 in most of coastal California and Hawaii; from 5 to 8 in central California and Florida; between 4 and 5 in Arizona, Maryland, Massachusetts, New Jersey, Oregon, Rhode Island, and Washington; and between 3 and 4 in Denver and Minneapolis–St. Paul.

The only state with a statewide growth-management law that did not see high housing prices in the recent bubble was Tennessee, probably because its law was implemented too late to create shortages. The only state to see a major housing bubble without state or local growth-management planning was Nevada. Nevada's prices are high because the federal government owns nearly 90 percent of the land in the state. Before 2000, the sale of federal land to developers in the fast-growth regions around Las Vegas and Reno maintained Nevada's housing affordability. Such sales slowed in 2001, leading to a rapid escalation of land and housing prices. In effect, the federal government, rather than state or local governments, is acting as the growth manager in Nevada.

In sum, the evidence is overwhelming that state and local land-use restrictions—not loose credit, speculators, or Federal Reserve policies—are the real source of the recent housing bubble:

- Housing prices mainly bubbled in states and regions with growth-management plans, whereas they remained stable in regions without such plans.
- Long before the recent changes in the credit market, housing prices previously bubbled in Hawaii, California, and other states with growth-management planning.
- There is a strong correlation between the time when states and regions first implemented growth-management plans and when, soon after, housing prices in those regions first became unaffordable.

Fuel on the Fire

Although loose credit markets did not cause the housing bubble, they did make it worse than it might have been. And one of the main impetuses behind loose credit was, ironically, a federal law designed to reduce the risk to taxpayers of the mortgage market.

The Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac)—together known as ''government-sponsored enterprises'' or GSEs—were created to promote affordable homeownership. Since they are implicitly backed by the federal government, Congress worried that they might take unacceptable risks. So in the Housing and Community Development Act of 1992, Congress gave the Department of Housing and Urban Development the mission of overseeing and regulating the GSEs.

That new mission conflicted with HUD's primary mission, however, which ''is to increase homeownership, support community development and increase access to affordable housing.'' Moreover, HUD is far more politicized than the GSEs; while the latter are run as businesses for the benefit of stockholders, HUD is typically run by a politically appointed secretary who is usually a politician and who often has ambitions to return to electoral politics after leaving HUD.

Secretaries of HUD get little political benefit from announcing that, thanks to their oversight, Fannie Mae didn't go bankrupt again this year. Instead, they are rewarded for announcing that homeownership rates have increased. In recent years, Congress has particularly pressured HUD to increase homeownership among blacks and other low-income minorities.

In 1992, when Congress gave HUD oversight over the GSEs, the Census Bureau was finding that homeownership rates had declined from 1980 to 1990. Moreover, rates in California and Oregon had steadily declined since 1960.

HUD today has a program encouraging local planners to promote housing affordability by deregulating land uses. But even if HUD had been aware of the connection between land-use regulation and declining affordability in the 1990s, it had no authority to stop such regulation.

But the 1992 law did give HUD authority to regulate the GSEs. Rather than use this authority to protect taxpayers from risky investments, successive secretaries of HUD used this regulatory power to order the GSEs to accept higher risks in the name of increasing housing affordability. In effect, they tried to use the GSEs to counterbalance the loss of housing affordability resulting from land-use regulation.

First, in 1995, Henry Cisneros ordered that at least 42 percent of the mortgages the GSEs purchased must be for ''low- to moderate-income families.'' In 2000, Andrew Cuomo increased it to 50 percent. These rules led the GSEs to increase their purchases of subprime loans by 10 times. Then, in 2004, Alphonso Jackson increased the requirement to 56 percent, leading the GSEs to further increase their purchases of subprime loans. These purchases turned a previously minor market for subprime borrowers into a major segment of the mortgage market.

The Housing and Economic Recovery Act of 2008 addressed the conflict between HUD's missions by transferring HUD's oversight authority to a new, independent agency, the Federal Housing Finance Agency. In practice, HUD's Office of Federal Housing Enterprise Oversight merely changed its name and its director now reports directly to the president rather than to the secretary of HUD. Yet this leaves open the possibility that the president will direct the FHFA to promote greater risk taking in the name of housing affordability.

The 2008 act also creates an Affordable Housing Trust Fund, derived from an effective tax on the GSEs. In essence, this fund will work to make housing slightly less affordable for most people so as to make housing more affordable for a few people. Although the goal of affordable housing for low-income families is laudable, this is not an effective remedy. Since the real cause of unaffordable housing is land-use regulation, note the comment by economists Edward Glaeser and Joseph Gyourko, ''if policy advocates are interested in reducing housing costs, they would do well to start with zoning reform.''

Lessons Learned

Fannie Mae and Freddie Mac are nominally private enterprises, but they have the implicit backing of the federal treasury—backing that was affirmed by the September 2008 takeover of the two companies. Critics of the GSEs argue that this backing creates a moral hazard—that is, that GSE managers will take undue risks knowing that taxpayers will back up their losses. Worries about this moral hazard led Congress to give HUD oversight over the GSEs.

Yet Fannie Mae, which was created in 1938, operated successfully for 54 years before such oversight began. Ironically, it was the moral hazard created by giving oversight authority to HUD that proved to be the problem.

While that problem has apparently been corrected by having the director of the Federal Housing Finance Agency report to the president, this still leaves the GSEs open to political interference. To best insulate the GSEs from politics, Congress should relinquish government sponsorship of the GSEs and fully privatize them, as it did for Sallie Mae in 1995. This would hand oversight to the Securities and Exchange Commission and other authorities that regulate and monitor private financial institutions.

America's main housing affordability problems are the result not of market failure (which might justify GSEs) but of state and local land-use regulation that creates artificial housing shortages. The Environmental Protection Agency has proposed that Congress give it or another federal agency authority to impose growth-management policies nationwide in order to reduce greenhouse gas emissions. In fact, there is little evidence that growth management influences greenhouse gas emissions and strong evidence that growth management dramatically reduces housing affordability. Congress should reject any proposals to impose national growth-management planning.

Similarly, state legislatures that have passed growth-management laws or other laws giving cities regulatory control over rural land uses should recognize that these laws are the main impediment to housing affordability. Repeal of these laws (and legislative rejection of similar bills in the states that have not yet passed such laws) will do more to improve housing affordability and homeownership rates than federal programs like the GSEs.

Suggested Readings

O'Driscoll, Gerald P., Jr., ''Asset Bubbles and Their Consequences,'' Cato Institute Briefing Paper no. 103, May 20, 2008.

O'Toole, Randal. ''The Planning Tax: The Case against Regional Growth-Management Planning.'' Cato Institute Policy Analysis no. 606, December 6, 2007.

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