Statement before the Joint Economic Committee

Rebuilding the American Dream: Policy Approaches to Increasing Supply of Affordable Housing

Achieving Housing Abundance through State and Local Land Use and Zoning Reform

How to Overcome Government Regulatory Failures to Enable the Market to Increase the Supply of Affordable Housing

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Chair Heinrich and Vice Chair Schweikert, and distinguished Members of the committee, thank you for the opportunity to testify today.

Executive Summary

Housing affordability issues are real for many Americans.

As home prices and more recently mortgage rates have risen dramatically, many people can no longer afford to buy a home and have no choice but to remain renters. Since rents have also gone up, renters are feeling increasingly financially stretched. These increasing pressures have led to an increase in displacement and homelessness.

In this election year, Congress is feeling the urge to increase the supply of affordable housing.

Before taking any action, it should first consider a couple of misconceptions:

Misconception 1: The housing supply shortage is a market failure. Not true, it is rather a government regulatory failure.

Actions of all levels of government – from the implementation of restrictive zoning laws, the introduction of discretionary reviews in planning, and the rise of environmental laws and other regulations --- have made land scarce and homebuilding expensive. This has restricted private developers from building enough housing to keep up with demand. Today's housing shortage is estimated to be in the millions.

Misconception 2: The federal government can fix – or at least ameliorate - this shortage. Not true.

The federal government's track record in housing supply interventions is poor. Just consider how public housing, which is overseen and regulated by the Department of Housing and Urban Development (HUD), is crumbling. Or how the Federal Housing Administration's (FHA) expansion into high-risk single-family and multifamily insured lending ended up devastating whole communities during the late-1960s and early-1970s.

Likewise, the Low-Income Housing Tax Credit (LIHTC), established in 1986 to combat the lack of affordable housing, has done next to nothing to increase the supply of housing. According to one study, almost all LIHTC development would have been built by the market without any subsidies.[1]

If that's not enough, LIHTC also limits social mobility and the program is corruption-prone and complex, thus crowding out many smaller builders.

Misconception 3: The only way to add affordable housing is through subsidies and government programs. Not true.

The root cause is government regulatory failure – and no amount of money can fix that. The true policy solution lies at the state and local level. The literature is clear that the most effective way to add

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[1] Eriksen, Michael D., and Stuart S. Rosenthal. "Crowd out Effects of Place-Based Subsidized Rental Housing: New Evidence from the LIHTC Program." Journal of Public Economics 94, no. 11–12 (2010): 953–66. https://doi.org/10.1016/j.jpubeco.2010.07.002.

affordable housing is to build a lot of market-rate housing, which decreases the cost of both rented and owned homes. Removing this red tape could provide hundreds of thousands of new homes each year.

More supply helps tamp down the house price and rent appreciation of existing homes. As new market-rate housing is built, higher-income households will move into the new units, freeing up their now vacant lower-priced unit. This process—known as filtering-- repeats itself further down the home price ladder, as commonly seen in the new and used car market.

In the case of housing, new construction has not met demand, leading to a breakdown of the filtering process – or even a reversal, where lower income households are selling their older homes to higher income households. No wonder there is so little affordable housing available.

<u>Misconception 4</u>: institutional investors, junk fees, rent pricing algorithms, AirBnb, foreign buyers, or vacant homes are responsible for widespread housing unaffordability. Not true.

While these entities make easy scapegoats, they are at best symptoms of the supply-demand imbalance. To put it bluntly, housing was unaffordable even before many of these entities were established.

<u>Misconception 5</u>: Government can make housing affordable through various demand subsidies. Not true.

Such practices come in many forms -- looser lending policies, lower mortgage premia, downpayment assistance, deeper vouchers, etc. What these policies have in common is that they increase demand against a severely limited supply. This benefits those that own homes or those that receive the subsidy, but it raises housing costs for all.

Having dispelled these misconceptions, the solution to today's housing shortage becomes clear:

1) The federal government needs to stay out.

Congress will soon consider two bipartisan bills to address high rental costs: an expansion of LIHTC and the creation of the Workforce Housing Tax Credit (WFHTC). Both programs would offer generous federal government subsidies for building new apartments. The WFHTC would extend eligibility for tenants earning below the area median. On a combined basis the two credits would expand eligibility to about three quarters of the nation's renters. Such a massive expansion of the state would waste taxpayer money, crowd out more private builders, and deter many families from advancing economically. Worst of all, it would do precious little to address the nation's housing supply problem. It would be bad policy for Congress to pass these bills.

On the lending side, the federal government also needs to abstain from the disproven notion of making housing more affordable through subsidies.

2) Zoning and land use policies are state and local issues and need to be tackled at these levels of government.

As numerous case studies from around the country have shown, the formula for successful housing reforms is simple:

- Enable by-right zoning,
- Allow greater density in lots of areas particularly around walkable and amenity-rich areas,

- Follow the KISS (Keep-It-Simple-Stupid) principle instead of micromanaging the process, and
- Complement high-rise Transit-oriented Development with Light-touch Density to provide naturally affordable (defined as unsubsidized housing with market-rate rents or prices) homes and wealth building homeownership opportunities with minimal changes to the built environment.

These actions will unleash the ingenuity of the American people by allowing builders of all sizes to build abundant market-rate housing over time. Fortunately, this is already happening – and entirely without federal involvement. In 2023 alone, Washington, Montana, and Vermont followed Oregon (2019) and California (2021) in passing statewide reforms that allow moderately higher density in the form of cost-effective duplexes, triplexes, and townhouses. [2]

The federal government could amplify this trend by auctioning off underutilized federal land without any strings attached for private market-rate development. As Sen. Lee has pointed out, there are plenty of opportunities, particularly out West. More land means more building, which will translate into more filtering and less affordability pressures.

On the other hand, federal involvement to influence state and local reform movements would result in complex, one-size-fits all solutions that violate the KISS principle and therefore perpetuate the housing supply problem.

Housing unaffordability is a self-inflicted wound, stemming from a government regulatory failure that perpetuates a massive supply-demand imbalance. This has resulted in higher home prices and rents relative to incomes. State and local supply reforms require no taxpayer subsidies and in the few areas where they have been implemented, they have been found to work. If more states and cities sign on, such reforms could provide hundreds of thousands of new homes each year and thus allow more Americans to access their own American Dream.

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[2] Harnessing Tailwinds on State and Local Land-Use Reform: A Bipartisan Playbook - Gov. Gianforte (MT): https://www.youtube.com/watch?v=E8DdGLJAx-s&ab_channel=AmericanEnterpriseInstitute; https://tcf.org/content/report/a-bipartisan-vision-for-the-benefits-of-middle-housing-the-case-of-oregon/; [2] https://www.aei.org/california-housing-conference/

1. Housing affordability issues are real for many Americans.

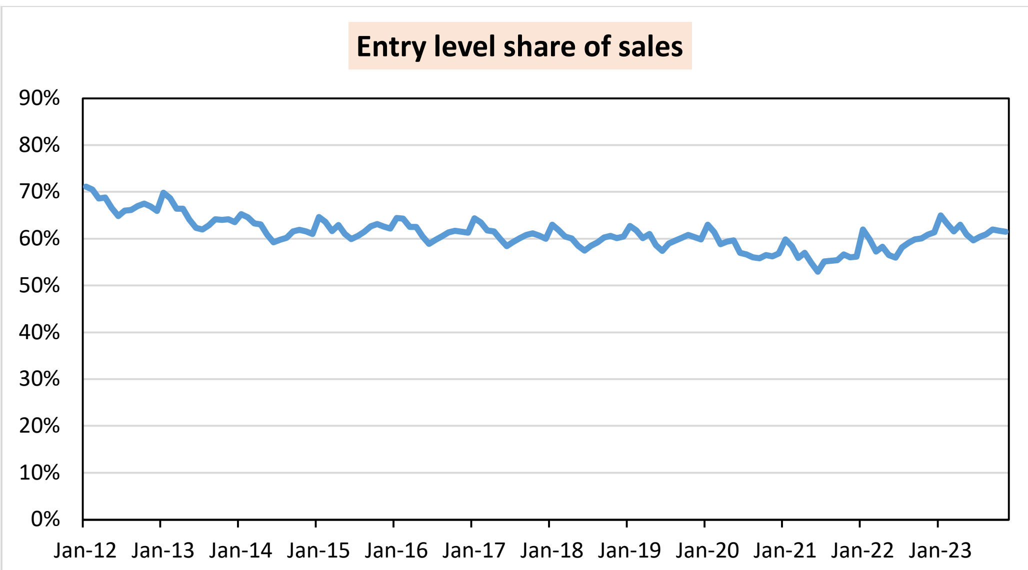
As home prices and more recently mortgage rates have risen drastically, many people can no longer afford to buy a home and have no choice but to remain renters. Since rents have also gone up, renters are feeling increasingly financially stretched. These increasing pressures have led to an increase in displacement and homelessness.

Due to rapid home price appreciation, potential homebuyers are getting crowded out of the market. While borrowers with incomes of $75,000 to $100,000 have the option to buy a lower-priced home, low-income Americans may be squeezed out of the market entirely.[3]

Here are a couple examples that illustrate the crowding out.

Example 1:

- The entry-level share of home sales, where most first-time homebuyers fall, has declined from 71% in Jan. 2012 to 61% in Sep. 2023.



Source: AEI Housing Center.

Example 2:

- At the same time, the incomes of entry level buyers have risen much faster than wages. For census tracts with the fastest home price appreciation (HPA) (+125% from 2012-2020), we observe borrower income growth (+50%) that is twice the rate of national income growth (~27%).
  - Unfortunately, it is highly implausible that the incomes for these neighborhoods have gone up that fast. Instead, it is more likely that more-affluent households are buying in these neighborhoods.

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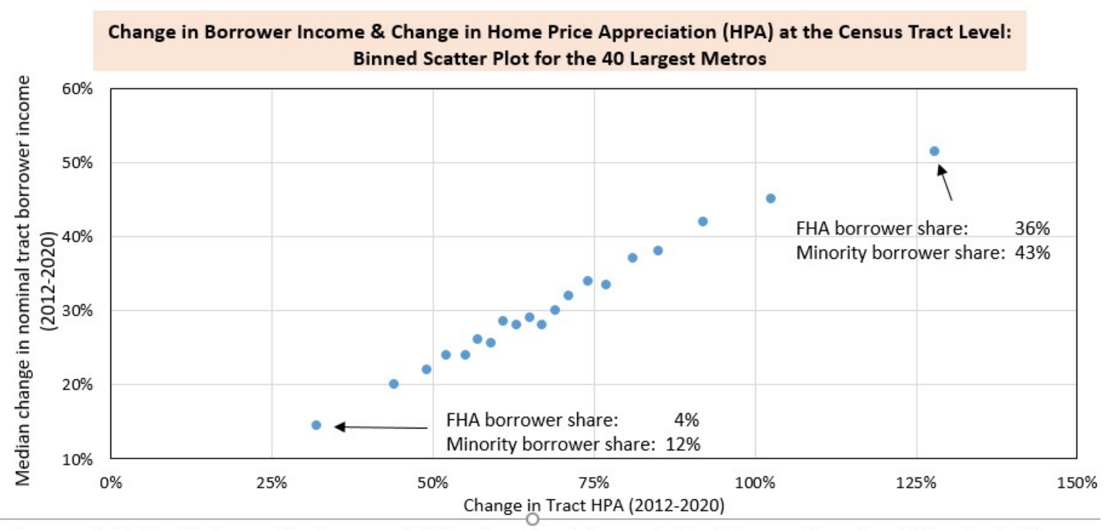
[3] https://www.wsj.com/articles/in-covid-19-housing-market-the-middle-class-is-getting-priced-out-11644246000?mod=mhp

- For example:
  - In 2012, the borrowers purchasing in census tract A had a median income of $40,000.
  - By 2020, these borrowers should be making $51,000 according to wage statistics from the Atlanta Fed.
  - However in 2020, we observe that the borrowers now purchasing in census tract A have a median income of $61,000.
  - Had the borrowers from 2012 not purchased in 2012, but rather tried to purchase in 2020, their income would not have sufficed to compete with the higher income borrowers that actually purchased in 2020.

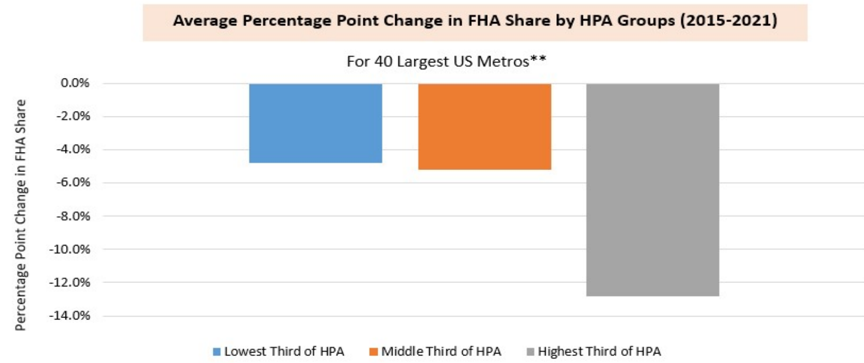
- The census tracts with the fastest HPA also had the highest share of FHA purchase loans (an indicator for lower-income) and minority borrowers.



Note: Tracts are weighted by their respective loan counts. Binned scatter plot accounts for differences in metros. FHA and minority borrower shares are for 2020. HPA stands for constant-quality home price appreciation
Source: HMDA and AEI Housing Center, www.AEI.org/housing.

<u>Example 3:</u>

- The top one-third of large metros with the highest growth in HPA have seen a 13 percentage point reduction in FHA purchase loan share compared to a 6 percentage point reduction for the two-thirds of metros with lower levels of HPA.
- Since FHA is a proxy for lower-income and minority borrowers, this trend is indicative of substantial crowding out of low-income and minority potential homebuyers.



* FHA purchase share is used as a proxy for lower income, minority, first-time, and first-generation borrowers
****Metro Cities in Lowest Third HPA Category**: Baltimore, MD; Chicago, IL; Cincinnati, OH; Cleveland, OH; Houston, TX; Kansas City, MO; New York, NY; Philadelphia, PA; Pittsburgh, PA; Raleigh, NC; San Antonio, TX; St. Louis, MO; Virginia Beach, VA; Washington, DC.
Metro Cities in the Middle Third HPA Category: Austin, TX; Boston, MA; Cape Coral, FL; Charlotte, NC; Columbus, OH; Dallas, TX; Detroit, MI; Indianapolis, IN; Jacksonville, FL; Los Angeles, CA; Miami, FL; Minneapolis, MN; North Port, FL.
Metro Cities in Highest Third HPA Category: Atlanta, GA; Denver, CO; Las Vegas, NV; Nashville, TN; Orlando, FL; Phoenix, AZ; Portland, OR; Riverside, CA; Sacramento, CA; San Diego, CA; San Francisco, CA; Seattle, WA; Tampa, FL.

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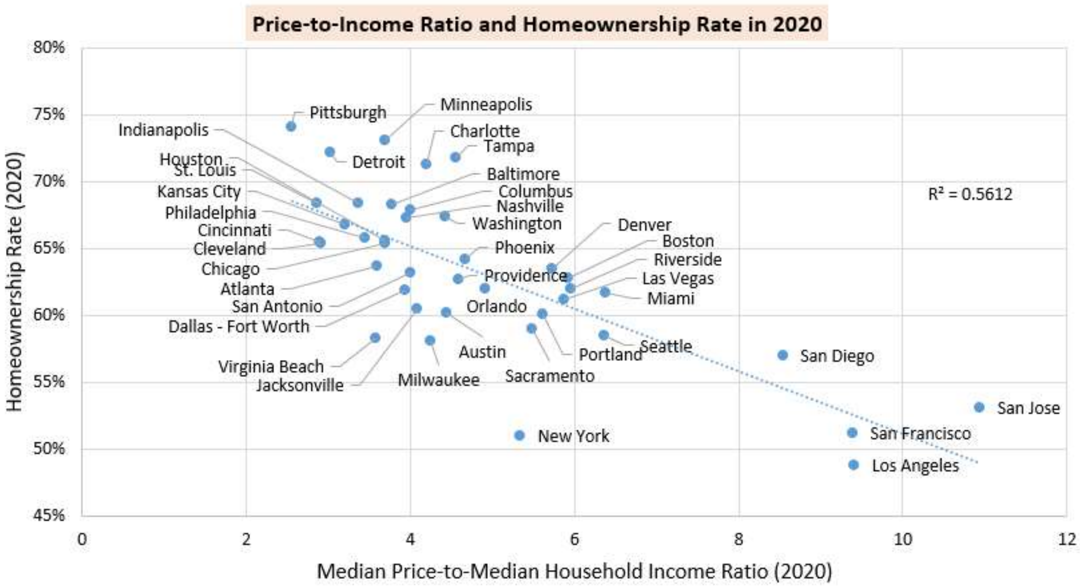
Source: American Community Survey, Public Records, and AEI Housing Center, www.AEI.org/housing.

The rapid home price appreciation, which has far outpaced market fundamentals, is primarily affecting lower-income, first-time, and first-generation home buyers.

With increased competition for fewer and fewer affordable homes, potential entry-level buyers are increasingly outbid by individuals with slightly deeper pockets, who experience similar competition but higher up the price spectrum. These trends are indicative of the crowding out of potential low-income and minority homebuyers, driven by federal monetary and housing policies. (More on this below.) It is a violation of the Fair Housing Act.

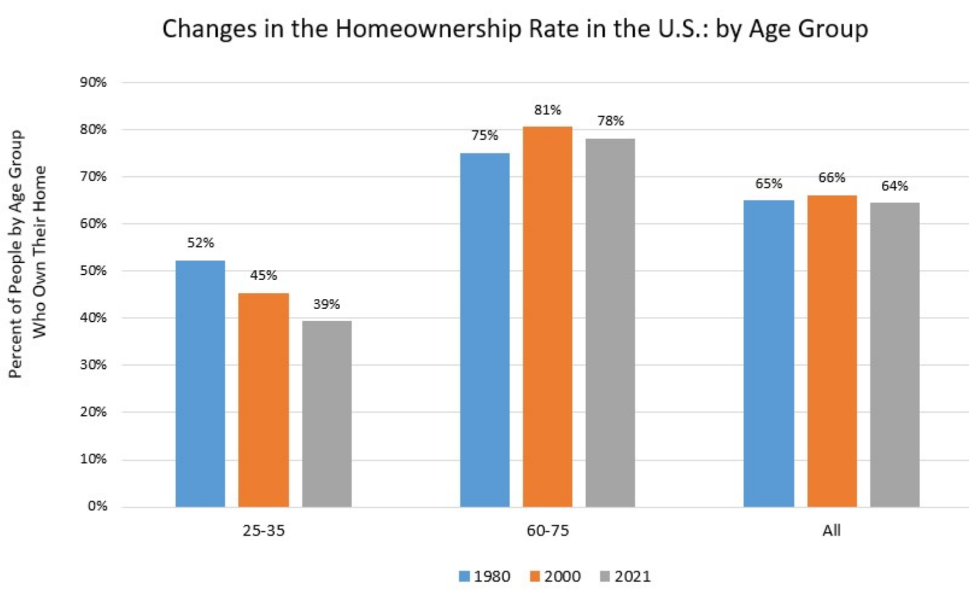
When would-be buyers are crowded out of the market, it creates problems downstream. The higher the prices are relative to income, the lower the homeownership rate is:

- If potential buyers can no longer afford homeownership, they continue to rent, which lowers the homeownership rate.
    - There is already a noticeable correlation between home prices to income and the homeownership rate for the largest metros.



Note: Data are for the largest 40 metros based on the number of households.
Source: Harvard Joint Center for Housing Studies, Census Bureau, and AEI Housing Center, www.AEI.org/housing.

- Compared to 1980, the homeownership rate for households aged 25-35 has dropped from 52% to 39%, while the overall rate has barely changed.



Note: Homeownership is defined as reporting that the property is owned by either the respondent or their spouse.
Source: 1980 and 2000 Census, and the 2021 (5-year) ACS data and AEI Housing Center, www.AEI.org/housing.

- With more borrowers being crowded out of homeownership, there is additional demand for rentals, which increases rents.
  - According to Zillow, rent appreciation peaked in March 2022 at 16% year-over-year. [4] This is up substantially from an average of around 4% year-over-year before the

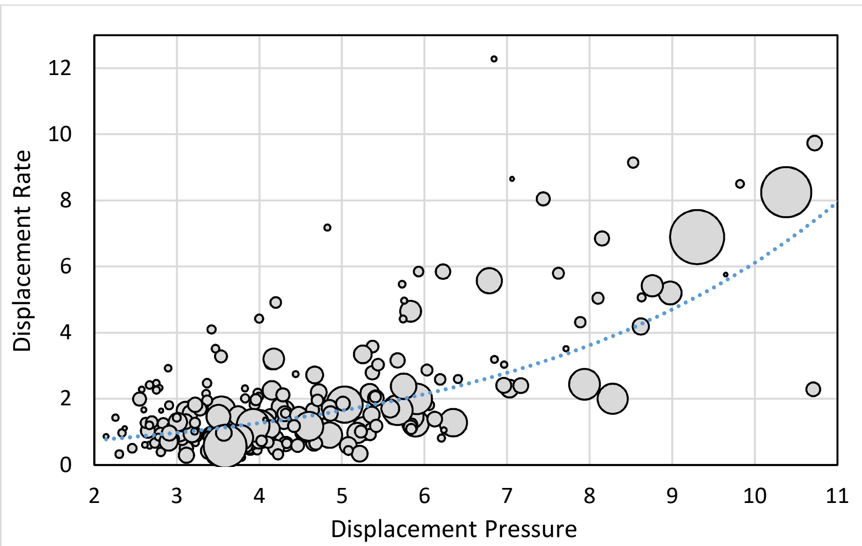
[4] https://www.zillow.com/research/september-2023-rent-report-33159/

pandemic. While rental increases have recently moderated back to their pre-pandemic average, rent levels today remain 30% above their December 2019 level. This is far greater than the 21% increase in wages over the same time.

- All these trends increase displacement pressure and signal higher rates of homelessness in the future.[5] As my colleague Ed Pinto has pointed out:

  "Point-In-Time (PIT) homeless and housing inventory counts (HIC) conducted in January 2023. The key finding was that homelessness reached a record high as the 2023 annual count increased 12% and 18% respectively from 2022 and 2017. The average rate of homelessness per 1000 population in 2023 was 20. … We found that areas with a displacement pressure ratio of 3.0 had an expected displacement ratio of 1.0 per 1000, but where the displacement pressure ratio is 7.0, the displacement rate was four times higher."[6]

Figure: Relationship between the median home price to median income ratio (displacement pressure) and the homeless per 1,000 people (displacement rate) at the Continuums of Care level: 2019



Note: Circles indicate the size of the CoC's population. Across 369 Continuums of Care (CoCs), we find a R^2 of .78 between Point-in-Time homeless counts per 1,000 people and the median price-to-income ratio (89% for CoCs with more than 1 million population), substantially higher than any of the other variables.
Source: Census, HUD, and AEI Housing Center.

[5] Out of a total of 54 variables tested, the single best predictor out of homelessness is the median price-to-income ratio. Across 369 Continuums of Care (CoCs), we find a correlation of 78% between Point-in-Time homeless counts per 1,000 people and the median price-to-income ratio (89% for CoCs with more than 1 million population), substantially higher than any of the other variable. Displacement rate is the number of persons per 1,000 residents that experience homelessness at a Point in Time (PIT). The rate for 2021 is an average of 2020 and 2022 due to interruptions in the count from the pandemic. Displacement pressure is the ratio between median home price and median income. The higher the ratio is, the higher the pressure is. Since 2012, price-to-income ratio has shot up from 3.35 to 4.29 in 2022.

[6] https://www.realclearmarkets.com/articles/2023/12/27/hud_homeless_count_fails_to_connect_dots_on_supply_and_displacement_1000856.html

2. In this election year, Congress is feeling the urge to increase the supply of affordable housing. Before taking any action, it should first consider a couple of misconceptions:

Misconception 1: The housing supply shortage is a market failure. Not true, it is a government regulatory failure.

Actions of all levels of government – from the implementation of restrictive zoning laws, the introduction of discretionary reviews in planning, and the rise of environmental laws and other regulations --- have made land scarce and homebuilding expensive. This has restricted private developers from building enough housing to keep up with demand. Today's housing shortage is estimated to be in the millions.[7]

Housing unaffordability is a self-inflicted wound. It stems not from a market failure, but from a government regulatory failure that has created a massive supply-demand imbalance that has driven home prices and rents higher.

The main culprits that have restricted supply to keep up with demand are:

- The federal government's implementations of single-family detached zoning for nefarious purposes in the 1920s.
- The rise of the Not-In-My-Backyard (NIMBY) movement in the 1950s.
- The rise of the environmental movement in the 1970s.

These actions replaced private property rights with communal rights and infringed on the market's ability to respond to price signals. (For more, see appendix 1.)

Nowhere is this more noticeable than in California, which has been at the forefront of many of the trends covered. What is often forgotten is that housing was not always unaffordable in California.[8] In 1970, the price-to-income ratio for California was largely affordable while being on par with the rest of the country (2.6). Yet by 2020, the price-to-income ratio in California was nearly double the level of the entire country (8.4 relative to 4.4 for the US).

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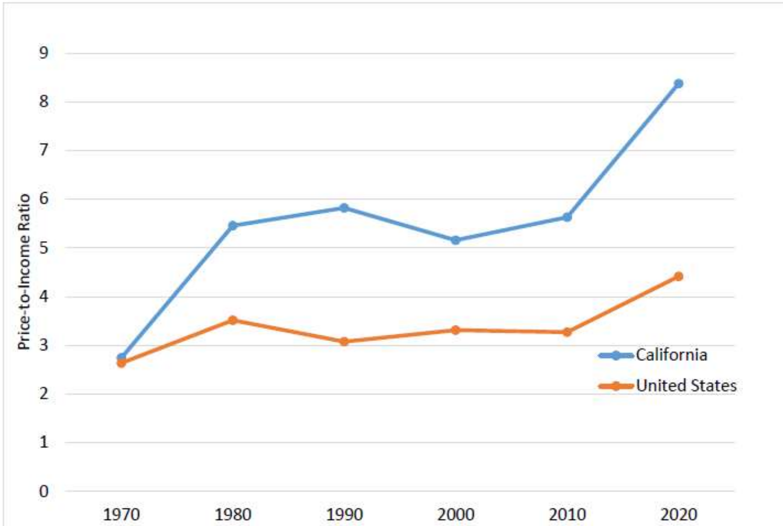
[7] See for example, Kingsella, Mike, Kolachalam, Anjali, and Leah MacArthur. "Housing Underproduction in the U.S. 2023." 2023., Khater, Sam. "One of the Most Important Challenges our Industry will Face: The Significant Shortage of Starter Homes." Freddie Mac: Perspectives, 23 Apr. 2021., or Corinth, Kevin, and Hugo Dante. "The Understated 'Housing Shortage' in the United States." IZA Working Paper, 2022.

[8] We calculate the ratio of these numbers, using median house prices as a numerator and median household incomes as the denominator. We use national median existing single-family homes prices from the National Association of Realtors and California Association of Realtors from this source for 1970, 1980, 1990, and 2000. For 2010 and 2020, we average monthly median home values from the California Association of Realtors' historical dataset, while we found 2020 median home values from the National Association of Realtors' most recent monthly report and estimate 2010 values from this data visualization. We use median household income for California and the United States from the US Census for 1990, 2000, 2010, and 2020. We find 1980 median household incomes from table B.79 from NHGIS. We use median national household incomes from 1970 Census data. For California, we are missing median household incomes in 1970, thus we impute household income using the ratio (1.03) of US-California household incomes in 1980.

Figure: Median Price-to-Median Income Ratios for California and the United States



Source: National Association of Realtors, California Association of Realtors, US Census, AEI Housing Center.

The conditions that have made California housing prices so high are spreading elsewhere. Across the country, the proliferation of land use regulations prevents the market from building more housing – particularly in high-demand places with well-paying jobs.

Additionally, the building industry has not fully recovered from the devastation of the Great Financial Crisis, thus further dampening housing construction. Then over the past couple of years, the Fed's rate policies first kept rates too low for too long before reversing course abruptly. Since many people refinanced during this period of low mortgage rates, many homeowners are locked-in, unwilling or unable to move. This effect has likely removed 100,000s of units from the market for years to come.

Despite all this, one thing is certain: Federal efforts to build more affordable housing have fallen flat for decades. This issue is not because of a lack of funds. (More on this below.) To achieve broad-based affordability, we need to unleash the private sector. Supply reforms in areas where they have been properly implemented have shown to result in meaningful supply additions. (More on this below).

<u>Misconception 2</u>: The federal government can fix – or at least ameliorate - this shortage. Not true.

The federal government's track record in housing supply interventions is poor. Just consider how public housing, which is overseen and regulated by the Department of Housing and Urban Development (HUD), is crumbling. Or how the Federal Housing Administration's (FHA) expansion into high-risk single-family and multifamily insured lending ended up devastating whole communities during the late-1960s and early-1970s. (For more, see appendix 2.)

Likewise, the Low-Income Housing Tax Credit (LIHTC), which was established in 1986 to combat the lack of affordable housing, has done little to increase the supply of housing. Passed by Congress in 1986, LIHTC subsidizes expensive housing made affordable with massive subsidies. For example in California, it now routinely costs 1 million dollars to build just one unit.[9] Given the amount of money at stake, it should come as no surprise that the program is also complex and corruption prone.

But since LIHTC funds are allocated to every state, largely based on population, the program attracts bipartisan support despite it doing next to nothing to increase the supply of housing. According to one study, almost all LIHTC development would have been built by the market without any subsidies.[10]

If that's not enough, LIHTC also limits social mobility by creating the perverse incentive for families to maintain incomes below the threshold in order to qualify for an apartment. This undermines the job prospects of parents and the long-run success of children.

In addition, LIHTC has serious design flaws:

- LIHTC is costly, complex, and corruption prone.[11] It builds expensive housing only made affordable by layering on subsidy upon subsidy. As the LA Times reports, "Affordable housing in California now routinely tops $1 million per apartment to build."[12]
- LIHTC requires other subsidies, primarily the federal housing voucher program. The dirty secret of LIHTC is that its subsidized rents are often still so high. For 2021 HUD reported that over 50 percent of LIHTC households reporting were also receiving rental assistance.
- LIHTC requires multiple layers of generous federal, state and local subsidies, the complexity of which caters to specialized and generally larger developers, along with legions of consultants to navigate the red tape of the various subsidy programs. [13]
- LIHTC benefits Fannie Mae and Freddie Mac, who are the largest financers of LIHTC projects.
- The LIHTC program has worked to reinforce racial discrimination. The City of Chicago reported that "since 2000, the majority of Chicago's LIHTC developments have been new construction located in high-poverty, majority Black areas, with a quarter located in higher-income "opportunity" areas."[14]
- LIHTC also limits social mobility by creating the perverse incentive for families to maintain incomes below the threshold to qualify for an apartment. This undermines the job prospects of parents and the long-run success of children.
- LIHTC fails to make housing more affordable and does little to nothing to increase the supply of housing. Instead, it simply crowds out the construction of market-rate housing for other middle-class families who do not receive the benefit, putting even more upward pressure on the rents

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[9] https://www.latimes.com/homeless-housing/story/2022-06-20/california-affordable-housing-cost-1-million-apartment

[10] Eriksen, Michael D., and Stuart S. Rosenthal. "Crowd out Effects of Place-Based Subsidized Rental Housing: New Evidence from the LIHTC Program." Journal of Public Economics 94, no. 11–12 (2010): 953–66. https://doi.org/10.1016/j.jpubeco.2010.07.002.

[11] https://www.cato.org/tax-budget-bulletin/low-income-housing-tax-credit-costly-complex-corruption-prone

[12] https://www.latimes.com/homeless-housing/story/2022-06-20/california-affordable-housing-cost-1-million-apartment

[13] https://www.aei.org/research-products/testimony/the-cost-of-complexity-in-low-income-housing-assistance/

[14] https://www.chicago.gov/city/en/depts/doh/provdrs/developers/news/2021/march/the-chicago-department-of-housing-announces-new-racial-equity-fo.html

they are forced to pay.[15] According to one study, almost all LIHTC development is accompanied by a commensurate decrease in the construction of market-rate housing.[16] This particularly hurts smaller, naturally affordable multifamily housing developers as they are pushed out of the market because they can't handle the red tape.

What is undeniable is that many of the housing problems we face today have occurred, not in spite of federal policies, but because of them.[17] This should serve as a warning for future proposals.

Misconception 3: The only way to add to affordable housing is through subsidies and government programs. Not true.

The literature is clear that the most effective way to add affordable housing is to build a lot of market-rate housing, which decreases the cost of both rented and owned homes. Building supply at middle price points is both naturally affordable and inclusionary. (More on this below.) More supply helps tamp down the house price and rent appreciation of existing homes.

Rigorous research conclusively shows the fallacy of supply skeptics' view that adding more supply does not slow home prices and rent growth. [18] An imbalance between the supply of homes and employment-driven demand is the main cause of metro home price appreciation (HPA).[19] Greater levels of new construction helps keep HPA more in line with income growth. If a metro adds lots of new employees, it also needs to add lots of new housing, and if you get behind, catch up by building more housing.

Our research has furthermore demonstrated that faster rates of new home construction can help tamp down metro home price appreciation. This is particularly true, and important, for faster-growing metros. The evidence is clear: Building more housing reins in home price increases, thus decreasing housing pressures on residents. (See next figure.)

[15] Corinth, Kevin, and Amelia Irvine. "Jue Insight: The Effect of Relaxing Local Housing Market Regulations on Federal Rental Assistance Programs." Journal of Urban Economics 136 (2023): 103572. https://doi.org/10.1016/j.jue.2023.103572.

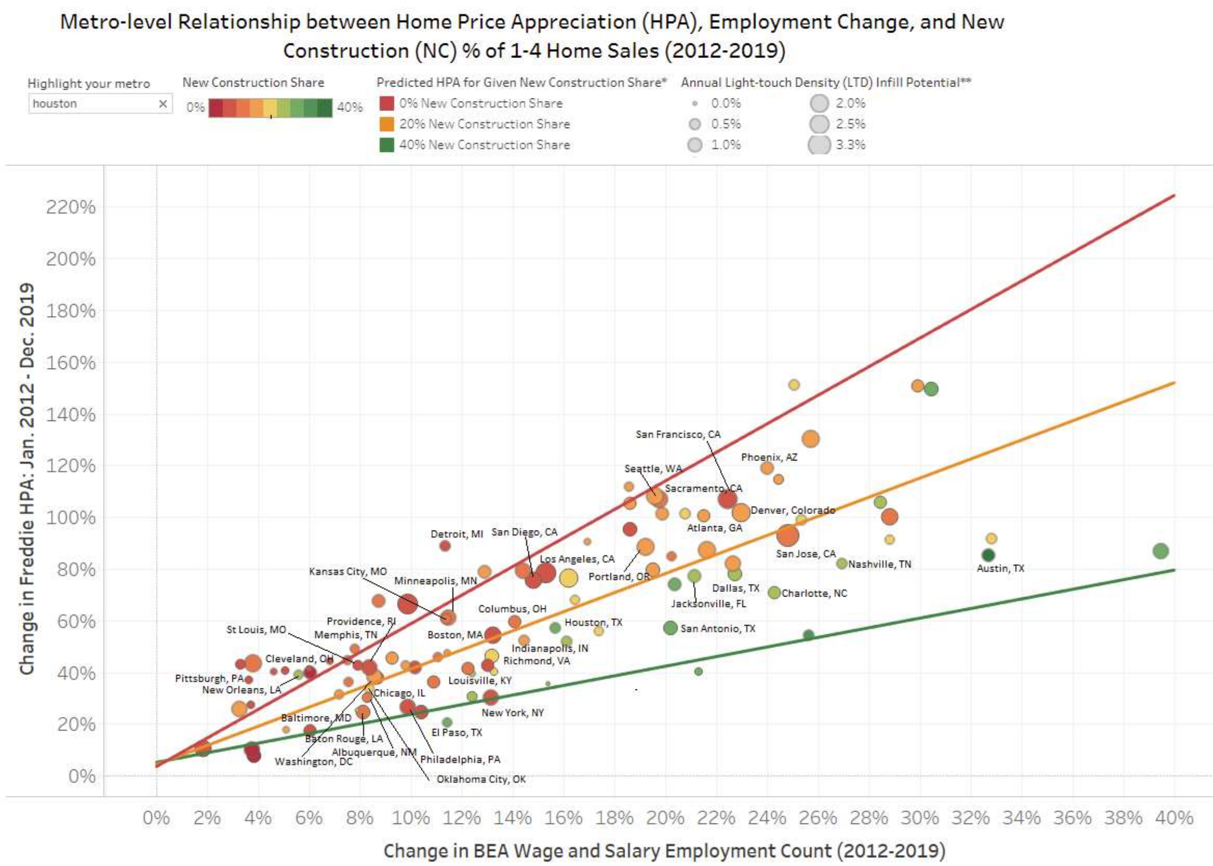
[16] Eriksen, Michael D., and Stuart S. Rosenthal. "Crowd out Effects of Place-Based Subsidized Rental Housing: New Evidence from the LIHTC Program." Journal of Public Economics 94, no. 11–12 (2010): 953–66. https://doi.org/10.1016/j.jpubeco.2010.07.002.

[17] While our research has found no evidence of systemic racism on the part of residential real estate appraisers or FHA's lenders, we have found evidence of vestiges of separate but equal policies promoted by the federal government and of ongoing federal policies that put low-income households in harm's way.

[18] Been, Vicki and Ellen, Ingrid Gould and O'Regan, Katherine M., Supply Skepticism Revisited (November 10, 2023). NYU Law and Economics Research Paper Forthcoming, Available at SSRN: https://ssrn.com/abstract=4629628 or http://dx.doi.org/10.2139/ssrn.4629628

[19] https://heat.aeihousingcenter.org/toolkit/supply_demand

Figure: Metro-level Relationship between Home Price Appreciation (HPA), Employment Change, and New Construction (NC) % of 1-4 Home Sales (2012-2019)



Source: BEA, Freddie Mac, and AEI Housing Center.

As new market-rate housing is built, higher-income households will move into the new units, freeing up their now vacant lower-priced unit. This process—known as filtering-- repeats itself further down the home price ladder, as commonly seen in the new and used car market.

In the case of housing, new construction has not met demand, leading to a breakdown of the filtering process – or even a reversal, where lower income households are selling their older homes to higher income households. No wonder there is so little affordable housing available.

Recently, "the battle cry of the low-income housing advocates has become that you can't build your way to affordability… Sightline Institute has tackled that notion directly. Not only can you build your way to affordable housing, in fact, building more supply may be the only effective way to reduce the pressure that is driving up rents and producing displacement. There's ample evidence for this position, but there's still the strong sense that addressing our housing problem by building more high-end housing is a cynical and ineffective kind of "trickle down" economics. … When there isn't enough supply, demand from higher income households floods down to older housing stock, driving up rents and reducing housing options for those with lesser means."[20] (City Observatory)

[20] https://cityobservatory.org/the-end-of-the-housing-supply-debate-maybe/

On this point of "trickle down" economics or filtering, Richard Ratcliff (1949:321) observed, "[I]t is not economically feasible to build and operate new rental properties under a rent scale that is within the reach of low-income families."[21] However, a healthy market will provide market-rate low-income housing through a process known as "filtering," and new housing construction can contribute to broad-based housing affordability without needing to provide publicly funded affordable housing.

Filtering works in four ways to keep home prices naturally affordable and displacement pressures low:

1. Under normal circumstances, homes move down in quality and value as they age (Ratcliff, 1949: 321).
2. On average, a homebuyer has a lower income than the sellers of the same home up and down the price range. This gap is wider and the buyer's income relative to the Area Median Income (AMI) is lower when more of the supply is affordable.
3. Naturally affordable homes contribute the most to the filtering process, as they quickly free up units for lower-income households. Units added at the highest price points require more households to move up before freeing an affordable unit; on the other hand, units at moderate price points require fewer households to move up before freeing an affordable unit.
4. As more supply is built, home price appreciation decelerates and rises at a rate more in line with wage growth. In turn, this relationship allows more filtering to occur, as the expanded stock of homes is more naturally affordable than if no additional stock was available.

This process can be better illustrated by looking at a market with a lot of filtering: the car market. With few barriers to increasing new car supply, additional cars can be built quickly at various price points in response to increased demand.[22] Although a lower-income household cannot afford a new Mercedes due to the high cost, they may be able to afford a 15-year-old Mercedes or a 5-year-old Chevrolet, which sell at a fraction of the new Mercedes. The new and used car market has naturally affordable options for households of all different economic means. In a functioning market, with new supply added at various price points, filtering ensures that households of virtually all incomes can afford a serviceable car and easily change cars as they move up the economic ladder.

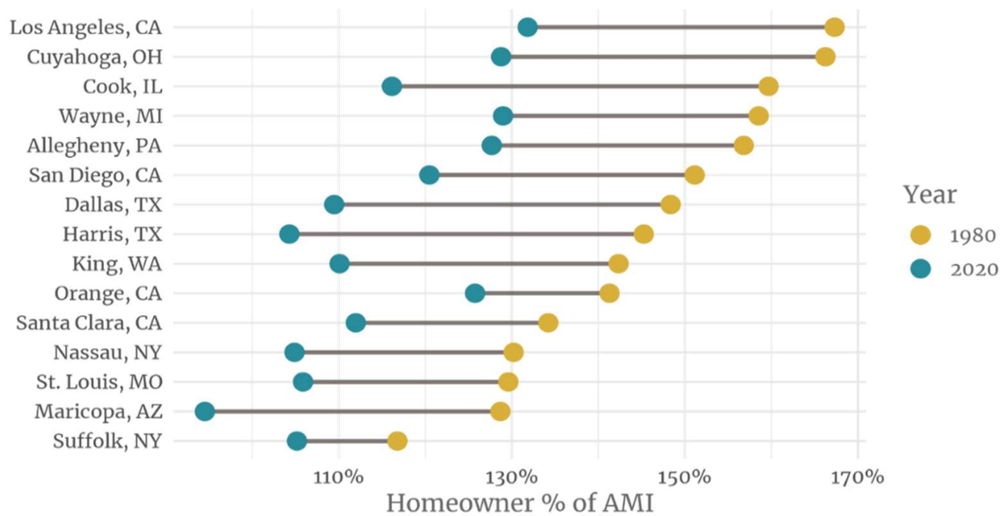
If car manufacturers could only legally build Ferraris, fewer new cars would be sold because fewer people could afford the high-priced Ferraris. With fewer cars being added to the market, the prices of existing cars would skyrocket. People willing to upgrade to a newer car would struggle to find a seller. The filtering-down of used cars would slow to a trickle. Cars that would otherwise be demolished would remain on the roads because they would become more valuable. The hypothetical case of only allowing the manufacturing of Ferraris is not dissimilar to the housing market, in which single-family detached (SFD) zoning and discretionary review have all but outlawed the production of naturally affordable housing.

To observe filtering effects, the income of occupant households can be calculated relative to their county median income in both 1980 and 2020 for single-family attached and detached homes built from

[21] The lack of new low-rent housing is essentially the result of the inherently costly nature of housing.
[22]https://www.kbb.com/cars-for-sale/new/washington-dc?searchRadius=75; This filtering car market did not work during the COVID-19 pandemic, as a chip shortage constrained new car construction, increasing the price of the existing used car stock.

1960 through 1979 for 100 counties. Filtering can be tracked over time because most of these homes still exist. The next Figure shows that for the 15 largest counties (by 1980 single-family units) across the board, housing built for relatively affluent households filtered down to less-affluent households by 2020, and housing built for households closer to the area median income filtered down to lower-income households.

Figure: Single-Family Detached & Attached Units Build 1960–1979



AMI = County Area Median Income of Households.
Note: Data show the top 15 tracked counties by number of single-family units in 1980.
Sources: AEI Housing Center; IPUMS; U.S. Census Bureau

Zoning, and SFD zoning in particular, artificially limits the highest and best use of the land. (More on this below). Additional units cannot be built on already developed, high-demand land; thus, home prices rise, and the filtering process breaks down. This process worsens when existing housing units are converted to McMansions.

Although newly built market-rate housing may not be affordable to many people with low incomes, an abundance of moderately priced new housing has been shown to enable greater homeownership opportunities for moderate-income, younger, and more diverse borrowers through filtering. (See the evidence on Seattle in appendix 1). Furthermore, the additional supply can keep home price appreciation more in line with wage growth. The evidence is clear: Freed from governmental regulatory failures, markets can provide abundant housing for everyone through filtering.

Light-touch Density (LTD) is a straightforward solution to most of the country's housing issues. It represents the low-hanging fruit in zoning reform, as it allows for modestly higher density than SFD zoning in many different ways, providing options for a jurisdiction to implement at least one.

For urban areas or nearby suburbs already built up, replacing SFD units with more LTD units or adding more LTD units to existing single-family units increases the units per acre, creating more naturally affordable units. The following are ways to increase the housing stock in infill areas:

- Existing single-family detached units can add a junior accessory dwelling unit (JADU) within the existing structure or build a separate freestanding detached or attached ADU on the same lot.[23]
- Older infill units can be torn down and replaced with a new duplex, triplex, fourplex, townhome, small multifamily structure, or cottage court.
- Single land parcels can be divided into two, and an additional single-family unit or multiplex unit could be built on the new parcel and sold off separately.

Builders can construct more affordable LTD units in outer suburbs or undeveloped areas—also called greenfield land by:

- Increasing the allowed density of undeveloped land.
- Adding additional floors or reducing the size of units in a planned apartment building to enable the land to be used more efficiently, decreasing the price point for each unit on both greenfield and infill projects.

Implementing these LTD zoning reforms would align market incentives with the need for more housing, resulting in greater housing supply at lower price points for both renters and owners, thus relieving displacement pressures. LTD represents a gradual return to the housing typographies that were present before the widespread implementation of SFD zoning.[24]

On the basis of multiple case studies and conditions favorable to LTD, approximately 2 to 3 percent of eligible units could be converted annually to LTD. This could add between 260,000 (at a density of up to two units per lot) and 930,000 (at up to eight units per lot) net new units per year nationwide over the next 30 to 40 years.[25] The conversion to more LTD homes within a neighborhood is slow and takes place over decades because a homeowner generally needs to sell before a builder can come in and convert a home.

Whether called LTD, missing middle, or gentle density, 2023 demonstrated bipartisan support for adding naturally affordable housing choices, reinforcing a growing tailwind of legislative accomplishments.[26] We need to build on these successes and convince more to follow suit.

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[23] With either a JADU or an ADU, the original structure is left intact and the JADU or ADU is sold in combination with the main structure. The gross living area (GLA) of the JADU or the ADU can vary from small to large and is not a defining attribute unless GLA is set by statute or ordinance.

[24] The share of LTD as a percentage of the national housing stock has shrunk drastically over time as local zoning ordinances enacted by municipal governments prohibited their construction on much or all of their land starting in 1920. From 1940 to 2018, the combined share of single-family attached units (SFA) and two- to four-unit structures as a share of all one- to four-unit structures declined from 26.5 percent in 1940 to 18.4 percent in 2019; had the 1940 percentage of LTD housing remained unchanged, the nation's housing supply would have increased by some 8 million units.

[25] These estimates resulted from evaluating every single-family residential property in the United States for its potential for LTD. For older residential properties on lots of sufficient size, an estimate is first made for an existing structure value, allowing an estimate of the current land share. For properties with a high enough land share, calculations are made to determine if a teardown and subsequent reconstruction of two to eight units (of varying sizes) on the same lots is feasible by assuming the construction cost per square foot of gross living area by using new single-family detached housing units built in the same area over the past 7–10 years. For more on the methodology, see appendix A.

[26] Washington State, Montana, and Vermont joined Oregon (2019) and California (2021) in implementing LTD. Austin, TX; St. Paul, MN; Charlotte, NC; Arlington, VA; Alexandria, VA and many other cities also took steps to

LTD needs to be combined with Light-touch Processing and Light-touch Permitting following the "Keep it Simple and Short" (KISS) approach.

The economics of housing construction favor moderately higher density and by-right LTD. These policies would allow for higher and better land use, unleashing what Strong Towns calls a "swarm" of property owners, small-scale builders, and local contractors to take on small-scale LTD conversion projects.[27] Evidence from AEI Housing Center case studies indicates that small-scale builders, many of whom are disproportionally minority-owned, carry out the majority of these LTD projects. To achieve this result, here are the lessons learned.

- What is required?
  - By-right approval of LTD housing
  - Simple rules regarding the number of units, floor-area ratio, and height restrictions permitted in a given lot.
- What helps?
  - Relaxing parking requirements
  - Instituting shot clocks, which can accelerate the timelines in slow-moving areas and create more dependable schedules for builders and homeowners attempting to plan for future construction. (Shot clocks are deadlines for a municipality to act on a plan. If a deadline is missed, the petitioner can assume the plan is approved.)
  - Preapproved design standards
- What hurts?
  - Low maximum floor-area ratio requirements
  - High minimum lot size requirements
  - Outsized parking or other requirements that increase construction costs or de facto prevent building LTD entirely.
  - Income limits and affordable housing fees and mandates
  - Rental bans
  - Owner-occupancy requirements
  - Rent controls
  - Inclusionary zoning
  - Impact fees
  - Anything not required for single-family homes

Among the "5 Ls" of construction-- land, laws, lumber, lending, labor-- land use laws are by far the biggest impediment to the private sector's ability to build more naturally affordable and inclusionary housing.

Our findings from various case studies across the country and other places demonstrate that LTD, when implemented by-right and following the KISS principle, can produce a significant supply response entirely through market forces. We estimate that each year LTD can add around 2% to the housing stock.

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unleash the private market. https://www.aei.org/events/harnessing-tailwinds-on-state-and-local-land-use-reform-a-bipartisan-playbook/

[27] https://www.strongtowns.org/journal/2021/2/3/unleash-the-swarm

Table 1. Light-Touch Density Case Studies

Case Study	Study Topic	Finding(s)
Seattle	Housing outcomes in the Lowrise Multifamily (allows for LTD) vs. SFD zone	LTD added ~3% to housing stock per year.
		LTD units are naturally affordable.
	The effect of a 2019 inclusionary zoning requirement on townhome development	Requirement halted most LTD development.
Palisades Park	Housing outcomes in Palisades Park vs. surrounding boroughs	LTD added ~2% to housing stock per year, which supported population growth.
		Lower property taxes and greater economic vibrancy resulted.
		Although legally permissible, procedural barriers such as greater lot size regulations stymie LTD.
Houston	Housing outcomes after Houston reduced the minimum lot size requirements within the I-610 Inner Loop	LTD added ~2% to housing stock per year.
		LTD units are naturally affordable.
Charlotte	Micro-level analysis of housing types in the R-22 vs. R-5 zone	Greater housing type diversity from LTD leads to lower-priced homes and greater economic diversity of residents.
Tokyo, Japan	Housing affordability and supply in Tokyo vs. other major global metropolitan areas	LTD added ~2% to the housing stock.
	Tokyo's zoning code	A market and property rights-based system governs land use and zoning, with minimal opportunity for interference from local homeowners, neighborhood groups, or elected officials.
Relationship Between Density, Gross Living Area (GLA), and Price	More than 500 counties in the largest 200 metropolitan areas	For single-family detached and attached homes built between 2000 and 2022, the greater the as-built density (number of units built per acre), the lower the GLA and home price. These reductions in price stem from the smaller GLA and lot size.
Rent by Structure Type and Year Built	50 states and the District of Columbia	LTD units are naturally affordable and inclusionary. Recently built (2010–21) LTD structures between 2 and 4 units have rents significantly lower than recently built 20+ units or single-family units, respectively.
Filtering	Homebuyer income as a percentage of seller income for more than 600,000 sales	Homebuyers tend to have lower incomes than sellers. Metropolitan areas with more economical homes tend to show greater levels of filtering down. Many of the metropolitan areas with modest filtering have high home values.
	Income of occupant households relative to their county median income in both 1980 and 2020 for single-family attached and detached homes built from 1960–79 for 100 counties	Across the board, older housing built for relatively affluent households had filtered down to less affluent households by 2020, and housing built for households closer to the area median income had filtered down to lower-income households.

Source: AEI Housing Center

<u>Misconception 4</u>: Institutional investors, junk fees, rent pricing algorithms, AirBnb, foreign buyers, or vacant homes are responsible for widespread housing unaffordability. Not true.

Governments at all levels should stop deflecting from their own policy mistakes by blaming the private sector for the market distortions they have created. While these entities make easy scapegoats, they are at best symptoms of the supply-demand imbalance.

The government regulatory failure described has been decades in the making. Institutional investors, junk fees, rent pricing algorithms, Airbnb, foreign buyers, or vacant homes are not responsible for widespread housing unaffordability. Housing was already unaffordable even before many of these entities were created. Furthermore, affordability has significantly worsened since the pandemic across the entire country, yet these entities are only present in a few markets or affect subsets of certain markets. (See appendix 3 for more.)

<u>Misconception 5</u>: Government can make housing affordable through various demand subsidies. Not true.

Such practices come in many forms -- looser lending policies, lower mortgage premia, downpayment assistance, deeper vouchers, etc. What these policies have in common is that they increase demand against a severely limited supply. This benefits those that own homes or those that receive the subsidy, but it raises housing costs for all.

The housing market is becoming less affordable because of misguided policies that boost demand. Such policies invariably encounter the paradox of accessible lending: When supply is constrained, credit easing and easy money will get capitalized into prices, making entry-level homes less, not more, affordable.

Credit easing or easy money merely permits one borrower to bid up the price against other potential borrowers for a scarce good.[28] Thus, much of the credit easing or easy money that federal policies provide are quickly capitalized into higher home prices. This is especially pertinent for entry-level homes, which are perennially in short supply. This puts upward pressure on home prices, does not expand access, and is dangerous-- concepts we have had to learn and relearn.

Consider just a few examples that should be discontinued or severely curtailed:

Federal housing policies:

- Foreclosure-prone affordable housing policies began in 1954, when Congress authorized FHA to insure the low downpayment, 30-year loan to buy an existing home, which primarily targeted low-income and minority borrowers.
  - These policies have subsidized debt by providing excessive leverage.
  - Coupled with the supply shortage, the increased demand from additional leverage has fueled unsustainable lending and higher home prices.
  - This is the paradox of accessible lending: When supply is constrained, credit easing will make entry-level homes less affordable.

[28] Fed Chairman Marriner Eccles, Federal Reserve Bulletin, The Current Inflation Problem, 1947, https://fraser.stlouisfed.org/files/docs/publications/FRB/1940s/frb_121947.pdf

    - During the Financial Crisis, these policies contributed to 12 million foreclosures and other forced dispositions, which were proportionally higher in low-income and minority neighborhoods.
    - These policies have not built generational wealth and despite the government's efforts over the last 60 years, homeownership today stands at about the same level as in 1964.

- Repeated FHA mortgage insurance premium cuts (2015 & 2023)
    - Our research on the 2015 cut estimates that home prices rose broadly, particularly for about 500,000 non-FHA borrowers first-time homebuyers. Each of these non-FHA homebuyers paid approximately $6,200 extra per house, a total extra payment of about $3.1 billion. From a cost-benefit perspective, this averages to an incredible $180,000 for each of the roughly 17,000 new FHA first-time buyers![29]
    - Despite the damning evidence, the FHA undertook another MIP cut in 2023 during an even more constrained housing market. As expected, FHA's once again share ballooned, as it poached business for other governmental agencies.

Furthermore, the administration has implemented or is considering a plethora of far-reaching changes to the housing finance system that will reshape housing finance and that will have many unintended consequences. (For more examples, see appendix 4.)

Federal Reserve policies:

The Fed's easy monetary policy during a seller's market has contributed to rapidly rising home prices and inflation.

- Quantitative Easing (QE) 3 announced in September 2012 coincides with the start of the current housing boom.
- QE4 announced in March 2020: While justified at the beginning of the pandemic, it became quickly clear that the housing and labor markets did not need the massive support. The Fed is finally, albeit belatedly and slowly, unwinding the GSE asset purchases.
- Artificially low interest rates: All else equal a 1 ppt. drop in the mortgage rates translate into a 9% increase in buying power. Since all borrowers see a decrease in monthly housing costs from the lower interest rate, most of buying power gets capitalized into higher home prices, thus benefitting the home seller, not the buyer. In addition, lower rates attract new buyers into the market (second or investment homebuyers, renters, etc.), thus also increasing the pool of potential buyers.

For more on the Fed's policies, see Appendix 5.

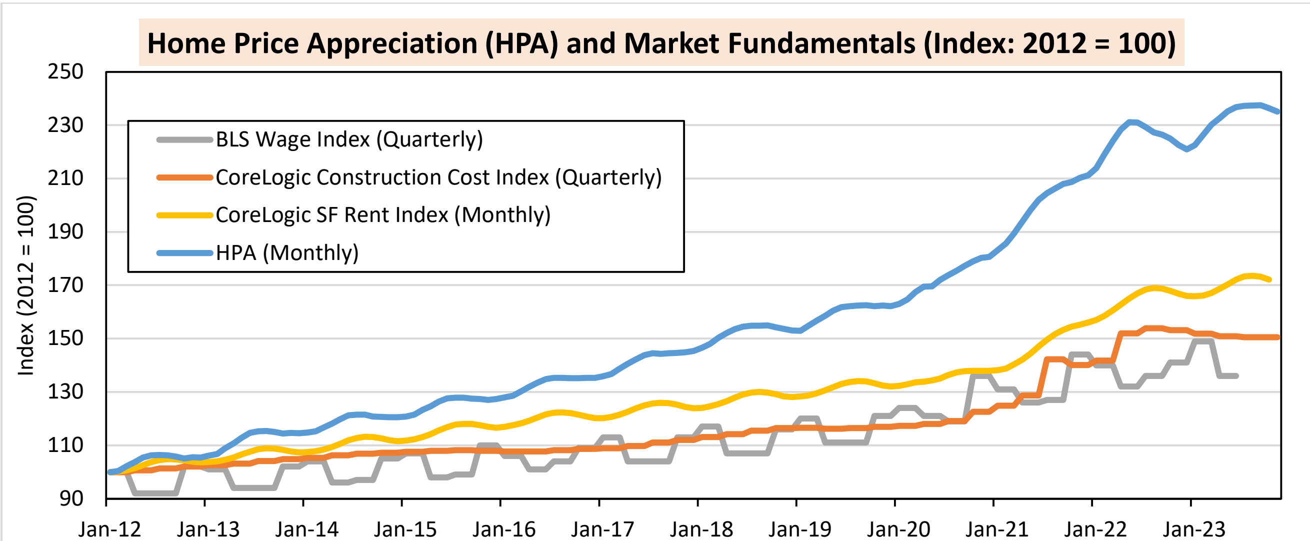
Policies by the federal government and Federal Reserve have been the culprit for crowding lower-income Americans out of the housing market. Ill-advised government policies and interventions have broken the housing ladder by inflating home prices. This has had a disparate impact on low-income and minority households that want to purchase at the entry-level.

Here are some examples on the effects of the single-family housing boom, which started in 2012, and had already manifested itself long before the worst excesses of the pandemic:

[29] https://www.aei.org/wp-content/uploads/2018/01/Davis-Oliner-Peter-Pinto-Jan-2018-AEI-WP-rev.pdf

- Since 2012, home price appreciation has far outpaced the growth in market fundamentals (wages, construction cost, rents).

Figure 5: Home Price Appreciation (HPA) and Market Fundamentals (Index: 2012=100)



Note: Data are for the entire country. Wage data come from the Quarterly Census of Employment Wages (QCEW). Source: CoreLogic, BLS, and AEI Housing Center, www.AEI.org/housing.

- Since 2012, home prices have appreciated 135%. Entry-level prices are up slightly more (144%).
- Home price appreciation (HPA) has further accelerated in the aftermath of the pandemic.
  - Since Jan. 2020 prices are up 44%.
- Affordability has been worsening with the median price to median income ratio increasing from 3.35 in 2012 to 4.29 in 2022.[30]

Because of this boom, home prices levels will be higher for years, which means that all subsequent buyers have to match that level.

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[30] https://www.aei.org/wp-content/uploads/2018/01/Davis-Oliner-Peter-Pinto-Jan-2018-AEI-WP-rev.pdf

3. Having dispelled these misconceptions, the solution to today's housing shortage becomes clear.

1) The federal government needs to stay out.

The federal government has a poor track record with housing reform, and there is little that the federal government can or should do that would not make the situation worse or violate the 10th amendment. Since there is no quick fix, it is best to give states and cities time to work out their supply shortages through reforms that unleash the free market through zoning and land use reforms. The good news is that many jurisdictions are moving in the right direction and the pace is quickening.

On the lending side, the federal government also needs to abstain from the disproven notion of making housing more affordable through subsidies (the paradox of accessible lending).

What federal entities should do:

- **Congress should not expand, but eliminate the Low-Income Housing Tax Credit (LIHTC)**

For the reasons outlined above.

- **Congress should not establish the Workforce Housing Tax Credit (WFHTC)**

Despite ample research on the impact of LIHTC, policymakers are seeking to make a bad situation worse by expanding it to middle-income tenants as well. The WFHTC bill proposes to tackle the affordability problems by extending government subsidies further up the income distribution, by offering tax credits to apartment builders who promise to charge their tenants "affordable" rents. It would operate almost exactly like the LIHTC, but instead of restricting the benefits to families with incomes below 60% of the area median, it would make all families with incomes below 100% of the area median eligible. We estimate that up to 76% of renters will qualify, rather than 53% under LIHTC.

Affordable housing programs only work by layering multiple generous rounds of federal, state, and local subsidies on top of each other. But that's not all: The dirty secret of LIHTC is that its subsidized rents are often still so high. For 2021 HUD reported that over 50 percent of LIHTC households reporting were also receiving rental assistance.[31] The WFHTC would give new impetus to expand all these programs along with growing the quasi-governmental mortgage giants, Fannie Mae and Freddie Mac, who happen to be largest financiers of LIHTC projects. It would be bad policy for Congress to pass this bill.

- **Congress should open federal land for housing development and reduce housing construction costs.**
    - Senator Mike Lee's Helping Open Underutilized Space to Ensure Shelter Act of 2022 (HOUSES Act) is a "unique way to alleviate the housing shortage without interfering with state and local decision-making, by allowing states to purchase certain general public lands for the purpose of developing new housing," according to a Joint Economic Committee

[31] https://www.huduser.gov/portal/Datasets/lihtc/2021-LIHTC-Tenant-Tables.pdf

report on the legislation.[32] Hugo Dante and Kevin Corinth estimate that the HOUSES Act could lead to the construction of 2.7 million more homes in the United States, which would go a long way to close the supply shortage.
  - This federal land should be auctioned off to developers, with the stipulation that market-rate housing must be built. This would particularly help the Western U.S. as the federal government owns large swaths of land there. The passage of the *Southern Nevada Public Land Management Act*, which enabled the Bureau of Land Management to sell off federal lands around Clark County, NV starting in 1998, provides a legislative blueprint of how this could be done. This precedent was set by Sen. Harry Reid, who freed up federal land for the Las Vegas metro.

- **Congress should lower or do away with tariffs on construction materials that add thousands of dollars to the cost of construction, which home builders pass on to consumers.[33]**

- **The administration should not restrict logging on national forests, as this would keep or further inflate lumber costs.[34] Instead, it should open more areas for logging.**

- **Congress should eliminate Davis-Bacon prevailing wage requirements on residential construction.** The Associated Builders and Contractors summarized the impact of prevailing wages:
  - "The Congressional Budget Office estimates that repealing the 1930s-era Davis-Bacon Act would save the federal government $24.3 billion in spending between 2023 and 2032. A May 2022 study found that the Davis-Bacon Act costs taxpayers an extra $21 billion a year, increases the price tag of construction projects by at least 7.2% and inflates construction workforce wages by 20.2%, compared to local market averages, if the DOL calculated prevailing wages using modern and scientific methodology via the U.S. Bureau of Labor Statistics."[35]
  - The Terner Center at the University of California Berkley found that "projects with prevailing wage requirements cost an average of $30 more per square foot than those without wage requirements, after controlling for whether or not a project was affordable, as well as project size, region, construction type, and the year construction started."[36]

- **Congress should eliminate the mortgage interest tax deduction on second homes, which subsidizes the purchase of second homes, thus increasing demand for limited housing supply.[37]**
  - A conservative estimate is that over 10 years about 600,000 second homes, or 10% of the outstanding stock, would convert to use by a primary resident. Of new construction sales, perhaps 150,000 units over 10 years would be sold as primary, instead of a secondary

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[32] https://www.jec.senate.gov/public/index.cfm/republicans/2022/8/the-houses-act-addressing-the-national-housing-shortage-by-building-on-federal-land

[33] https://www.americanactionforum.org/insight/tariffs-are-increasing-homebuilding-costs/; https://www.pwsc.com/how-are-new-home-builders-affected-by-tariffs/

[34] https://www.washingtonpost.com/climate-environment/2023/12/19/old-growth-logging-forest-service

[35] https://www.abc.org/News-Media/Newsline/dol-increases-costs-for-contractors-and-taxpayers-with-davis-bacon-final-rule

[36] https://ternercenter.berkeley.edu/research-and-policy/hard-construction-costs-apartments-california/

[37] https://www.wsj.com/articles/to-spur-homeownership-stop-subsidizing-it-1512432498

residence. In total, this small policy change may add the equivalent of a full year of new home construction over 10 years.[38]

- **Congress or the administration should not establish grants for localities that reform their zoning and land use policies.**
    - The devil is always in the details. Where incentives fail, mandates follow. The federal government's solutions to zoning reform will almost invariably have a bias towards heavy-handed government interventions and suffer from poor analysis. It could undo all the progress that some states and cities are making.
        - These proposed solutions will tilt heavily towards expensive and small rental units made affordable by layer upon layer of subsidies and do little to promote naturally affordable, family-sized for sale homes, that will increase homeownership and intergenerational wealth building.
        - It is also highly likely that federal grants will have strings attached, such as an income-based occupancy requirement.
            - A recent example is an assessment and recommendation published in HUD's clearinghouse for innovative state and local strategies that reduce the impact of regulations and promote affordable housing.[39] HUD analyzed Seattle's Mandatory Housing Affordability (MHA) fund and concluded it should be implemented by other cities. HUD's assessment ignores historical context and unintended consequences, thereby presenting a one-sided picture. While HUD singles out the “success” of the MHA to create hundreds of new affordable units since its inception in 2019, it ignores the thousands of units that were not built because of it. In that sense, the MHA has undone decades of progress from Seattle’s prior upzoning reforms that freed the market from government regulations. (For more, see appendix 4.)

- **Congress should stop pouring tens of billions of dollars into deteriorating public housing, in a futile effort to get public housing right.**
    - Place-based housing subsidies like public housing and LIHTC perpetuate income and racial segregation, and all too often, deteriorate into poorly maintained projects.

- **Congress should not provide tens of billions in subsidies to rehabilitate millions of homes.**
    - The history of subsidized rehabilitation programs is rife with cost overruns, failed efforts, and corruption. Such a program has also never successfully scaled.

- **On the demand side, Congress and the administration should avoid programs that boost demand against a limited supply.**
    - There is a growing consensus that the solution to make housing more affordable is to increase supply, not to ease credit, increase government subsidies, or suppress interest

[38] https://fred.stlouisfed.org/series/HSN1F
[39] https://thehill.com/opinion/4389523-to-fix-their-housing-shortage-in-2024-cities-and-states-should-turn-to-market/

rates. Even a few progressive think tanks and cities have come around to this view.[40] In order to stop the price spiral that is pricing lower-income Americans out of the housing market and driving up rents, we need to foremost address housing supply and stop demand boosters.
  - Unfortunately, the federal government has not yet learned this lesson as both the federal government and Federal Reserve have implemented plenty of demand boosters over the last couple of years and is considering many more. (For a list, see appendix 5).

- **All levels of government should consider reducing regulatory barriers on builders.**
  - According to two studies by the National Association of Home Builders (NAHB), "Regulations imposed by all levels of government account for $93,870, or 23.8% of the current average sales price ($397,300) of a new single-family home" and they account "for an average of 40.6 percent of multifamily development costs."[41]
  - These studies don't break out the cost by entity, but they highlight how some federal policies can affect these higher costs:
    - "State and local jurisdictions adopt and enforce building codes, but federal policymakers are also active in the development of international model codes, and they promote the adoption of certain code editions. For example, the U.S. Department of Energy encourages states to adopt the most stringent versions of the model energy codes. Various policy groups, industry organizations and individual companies also advocate for code changes that promote specific goals. These changes do not always balance the needs of housing affordability and have the potential to drive up construction costs without improving building safety or integrity."
      - According to the NAHB, changes to building codes over the last 10 years alone have added about 11.1% to the cost of multifamily buildings and over 6% to the cost of single-family homes.
  - In regard to complying with Occupational Safety and Health Administration (OSHA) requirements, the single-family report points to:
    - "particular standards for attempting to regulate risks that don't really exist in residential construction (e.g. beryllium), imposing costs significantly greater than needed to ensure worker safety (e.g. silica) or accomplishing little beyond driving up recordkeeping costs (e.g. Volks rule)."
    - These regulations don't apply to construction but according to the NAHB, OHSA standards add about 2.7% to the cost of multifamily buildings and over 1% to the cost of single-family homes. This leaves room to lower costs by cutting some of the red tape.

[40] See for example https://cityobservatory.org/the-end-of-the-housing-supply-debate-maybe/ and https://www.sightline.org/2017/09/21/yes-you-can-build-your-way-to-affordable-housing/.
[41] https://www.nahb.org/blog/2021/05/regulatory-costs-add-a-whopping-93870-to-new-home-prices/; https://www.nahb.org/news-and-economics/press-releases/2022/06/new-research-shows-regulations-account-for-40-point-6-percent-of-apartment-development-costs

2) **Zoning and land use policies are state and local issues and need to be tackled at these levels of government.**

As numerous case studies from around the country have shown, the formula for successful housing reforms is simple:

- Enable by-right zoning,
- Allow greater density in lots of areas particularly around walkable and amenity-rich areas,
- Follow the KISS (Keep it Simple Stupid) principle instead of micromanaging the process, and
- Complement high-rise Transit-oriented Development with Light-touch Density to provide naturally affordable homes and wealth building homeownership opportunities with minimal changes to the built environment.

These actions will unleash the ingenuity of the American people by allowing builders of all sizes to build abundant market-rate housing over time. Fortunately, this is already happening – and entirely without federal involvement. In 2023 alone, Washington, Montana, and Vermont followed Oregon (2019) and California (2021) in passing statewide reforms that allow moderately higher density in the form of cost-effective duplexes, triplexes, and townhouses.[42]

<u>What state and local entities should do:</u>

- **Follow the formula for successful housing reform as outlines above.**
    - Zoning codes and land use regulations limit what types of housing can be built and where, thus making land artificially scarce and expensive.
    - Removing this red tape could unleash the ingenuity of the American people by allowing builders of all sizes –not just those that can navigate the bureaucracy -- to get to work.

- **Study housing reform recommendations and adapt those most applicable to their jurisdiction.**
    - The Mercatus Center's Salim Furth and Emily Hamilton have compiled an excellent list of recommendations for state housing reforms. The list outlines a menu of useful options such as direct limits on local regulation, streamlining procedures, fiscal innovations, and updating construction standards.[43]

- **Take a look at regulations that impede the construction industry or increase construction costs.**
    - This appears to be happening. Montana offers one example of a state that is already finding creative ways to deal with their housing and labor shortages. For example, at a joint AEI-Progressive Policy Institute event entitled "Harnessing Tailwinds on State and Local Land-Use Reform: A Bipartisan Playbook," Gov. Greg Gianforte of Montana delivered the keynote

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[42] Harnessing Tailwinds on State and Local Land-Use Reform: A Bipartisan Playbook - Gov. Gianforte (MT): https://www.youtube.com/watch?v=E8DdGLJAx-s&ab_channel=AmericanEnterpriseInstitute; https://tcf.org/content/report/a-bipartisan-vision-for-the-benefits-of-middle-housing-the-case-of-oregon/; [42] https://www.aei.org/california-housing-conference/

[43] https://www.mercatus.org/research/policy-briefs/housing-reform-states-menu-options-2023

on the “Montana Miracle”—the successful passage of light-touch density and other market-oriented, supply-stimulating policies during 2023’s legislative session.[44]

    - Governor Gianforte overviewed Montana’s latest efforts to expand the state's construction workforce through workforce education and regulatory reform. Per Montana law, companies that sponsor an employee’s trade education are eligible to receive a 50% educational reimbursement. In addition, the journeyman to apprentice ratio changed from 2:1 to 1:2, which will increase the number of carpenters, plumbers, and electricians needed to build more housing. Then to address the lack of development specifically in rural and frontier areas, a modular housing company, Dvele, was recruited. With the additional tradesman and the capacity for modular housing construction, areas that do not have local construction companies – even in remote areas – can build new housing supply.
    - The state was also busy removing red tape with significant reforms to zoning and land-use regulations. First, ADUs and duplexes are allowed across the state, a potential boon to Light-touch Density construction. Second, land-use regulations were reformed to speed up the permitting process. Third, by-right zoning was legalized in 10 of Montana's largest cities and counties to eliminate the uncertainty of individual development projects. Fourth, standards for design review must now be objective, standardized, and necessary to protect public health and safety.
    - When asked about any help from the federal government, the governor responded that the state had it covered. This shows that the states as the laboratories of democracy are finding creative ways to address housing and labor shortages, even without – or particularly because of a lack of -- the federal government’s involvement.
  - Once a developer has secured the land, regulations from all levels of government – some useful without a doubt, but not all—add sizeable costs to build. Add laws that limit returns like eviction restrictions or outright bans, or rent control, and it’s no wonder that many private projects don’t pencil out.

- **Beware of federal involvement to influence state and local reform movements.**
  - This would result in complex, one-size-fits all solutions that violate the KISS principle and therefore perpetuate the housing supply problem.

Housing unaffordability is a self-inflicted wound, stemming from a government regulatory failure that perpetuates a massive supply-demand imbalance. This has resulted in higher home prices and rents relative to incomes. State and local supply reforms require no taxpayer subsidies and in the few areas where they have been implemented, they have been found to work. If more states and cites sign on, such reforms could provide hundreds of thousands of new homes each year and thus allow more Americans to access their own American Dream.

[44] https://www.aei.org/events/harnessing-tailwinds-on-state-and-local-land-use-reform-a-bipartisan-playbook/

Appendices:

Appendix 1: To Solve the Affordability Problem, Restore the Market Using Light-Touch Density

The overarching goal of policymakers should be to break the primacy of housing planners and return to market principles that largely governed land use before the implementation of widespread SFD zoning and excessive regulation. The tool to achieve this goal is light-touch density zoning, and the following section outlines how and why it leads to more abundant, naturally affordable, and inclusive housing.

What is light-touch density (LTD)?

Light-touch density (LTD) represents the low-hanging fruit in zoning reform, as it allows for modestly higher density than SFD zoning in many different ways, providing options for a jurisdiction to implement at least one.

For urban areas or nearby suburbs already built up, replacing SFD units with more LTD units or adding more LTD units to existing single-family units increases the units per acre, creating more naturally affordable units. The following are ways to increase the housing stock in infill areas:

- Existing single-family detached units can add a junior accessory dwelling unit (JADU) within the existing structure or build a separate freestanding detached or attached ADU on the same lot.[45]
- Older infill units can be torn down and replaced with a new duplex, triplex, fourplex, townhome, small multifamily structure, or cottage court.
- Single land parcels can be divided into two, and an additional single-family unit or multiplex unit could be built on the new parcel and sold off separately.

Builders can construct more affordable LTD units in outer suburbs or undeveloped areas—also called greenfield land:

- Increase the allowed density of undeveloped land.
- For both greenfield and infill projects, add additional floors or reduce the size of units in a planned apartment building to enable the land to be used more efficiently, decreasing the price point for each unit.

Implementing these LTD zoning reforms would align market incentives with the need for more housing, resulting in greater housing supply at lower price points for both renters and owners, thus relieving displacement pressures. LTD represents a gradual return to the housing typographies that were present before the widespread implementation of SFD zoning.[46]

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[45] With either a JADU or an ADU, the original structure is left intact and the JADU or ADU is sold in combination with the main structure. The gross living area (GLA) of the JADU or the ADU can vary from small to large and is not a defining attribute unless GLA is set by statute or ordinance.

[46] The share of LTD as a percentage of the national housing stock has shrunk drastically over time as local zoning ordinances enacted by municipal governments prohibited their construction on much or all of their land starting in 1920. From 1940 to 2018, the combined share of single-family attached units (SFA) and two- to four-unit structures as a share of all one- to four-unit structures declined from 26.5 percent in 1940 to 18.4 percent in 2019; had the 1940 percentage of LTD housing remained unchanged, the nation's housing supply would have increased by some 8 million units.

On the basis of multiple case studies and conditions favorable to LTD, approximately 2 to 3 percent of eligible units could be converted annually to LTD, which could add between 260,000 (at a density of up to two units per lot) and 930,000 (at up to eight units per lot) net new units per year nationwide over the next 30 to 40 years.[47] The conversion within a neighborhood is slow and takes place over decades (as seen in Figure 2) because a homeowner generally needs to sell before a builder can come in and convert a home.

Figure 2: An Illustration of Neighborhoods with Light Touch Density

Source: AEI Housing Center

How Light-Touch Density (LTD) Works when Properly Implemented

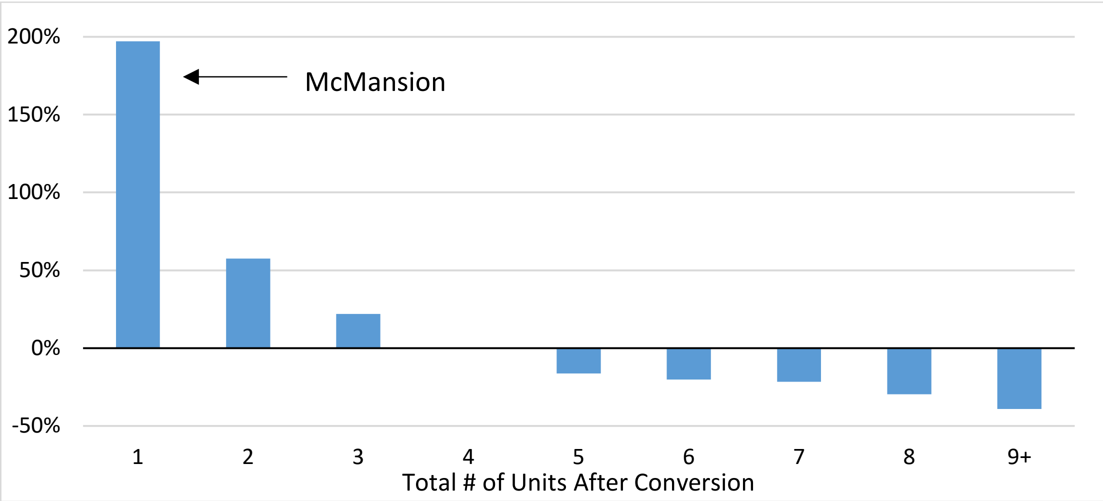
The conversion of older housing stock to newer, more plentiful housing stock releases housing price pressures and decreases displacement pressures. Freed from single-family detached (SFD) zoning and discretionary reviews, such conversion will occur naturally because builder incentives align with the market demand for more moderately priced housing.

A case study from Seattle, which allows LTD in Lowrise Multifamily (LRM) zones, demonstrates that homebuilders will always choose to maximize their profit, which, in this case, includes building moderately priced housing at a greater density. Figure 4 compares the median price of the property that the builder bought and eventually sold for approximately 12,000 conversions at various levels of total units after the conversion. When the builder built a McMansion, presumably because zoning limited the highest and best use, the sales price was almost 200 percent of the original unit price that the builder purchased. At higher units after conversion, that premium drops until the price change level is 0 percent

[47] These estimates resulted from evaluating every single-family residential property in the United States for its potential for LTD. For older residential properties on lots of sufficient size, an estimate is first made for an existing structure value, allowing an estimate of the current land share. For properties with a high enough land share, calculations are made to determine if a teardown and subsequent reconstruction of two to eight units (of varying sizes) on the same lots is feasible by assuming the construction cost per square foot of gross living area by using new single-family detached housing units built in the same area over the past 7–10 years. For more on the methodology, see appendix A.

at four units, and each unit sells at roughly the same price as the original purchase price. For additional units, the median price of the new units is lower than for the existing unit that the builder replaced. Not only does converting single units to multiple units create more net housing, but the price of housing for each unit goes down as more units are built.

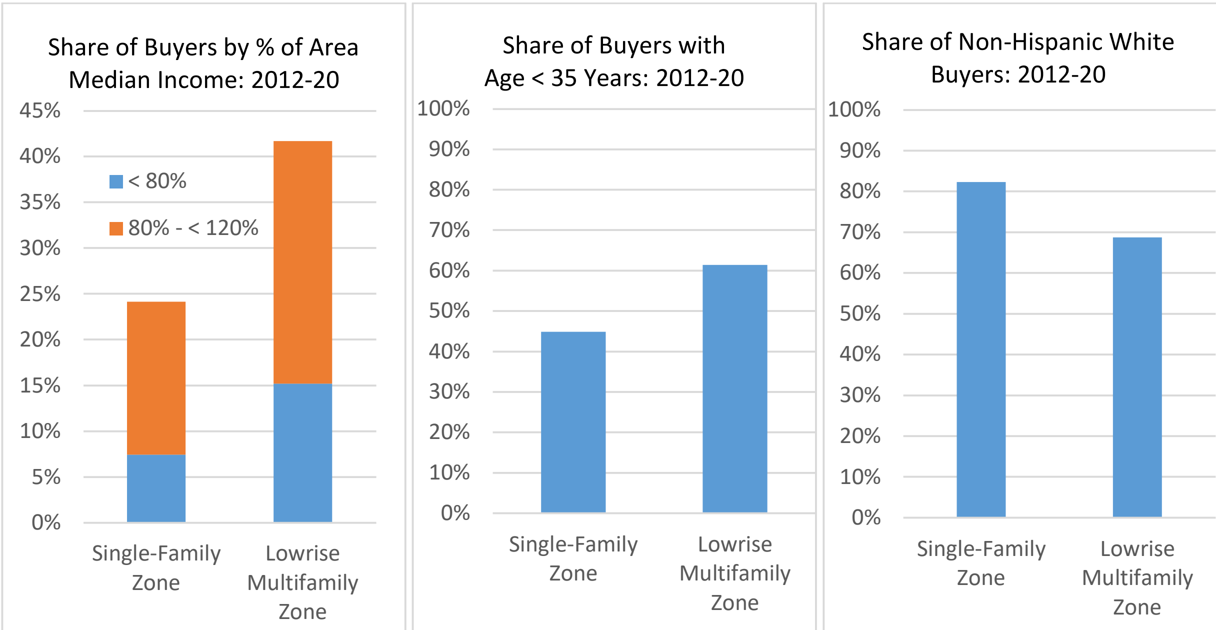
Figure 4: Conversion Properties: Median Price Change Between the Unit Replaced and the Median of the New Units Built, by Total Number of New Units



Notes: A conversion is defined as the act of tearing down an existing single-family detached structure and replacing it with a new structure of varying unit totals. Data pertain to more than 3,000 conversions identified in Seattle, which resulted in approximately 12,000 new units from the mid-1990s onward.
Source: AEI Housing Center

The additional moderately priced units also open up greater homeownership opportunities for a wider group of households. Seattle's experience shows that across income levels, age ranges, and racial/ethnic backgrounds, a more diverse group of people can purchase homes in its Lowrise Multifamily zone than in the SFD zone (see Figure 5).

Figure 5: Seattle's LTD Zone Enables Homeownership for a Wider Group of Households



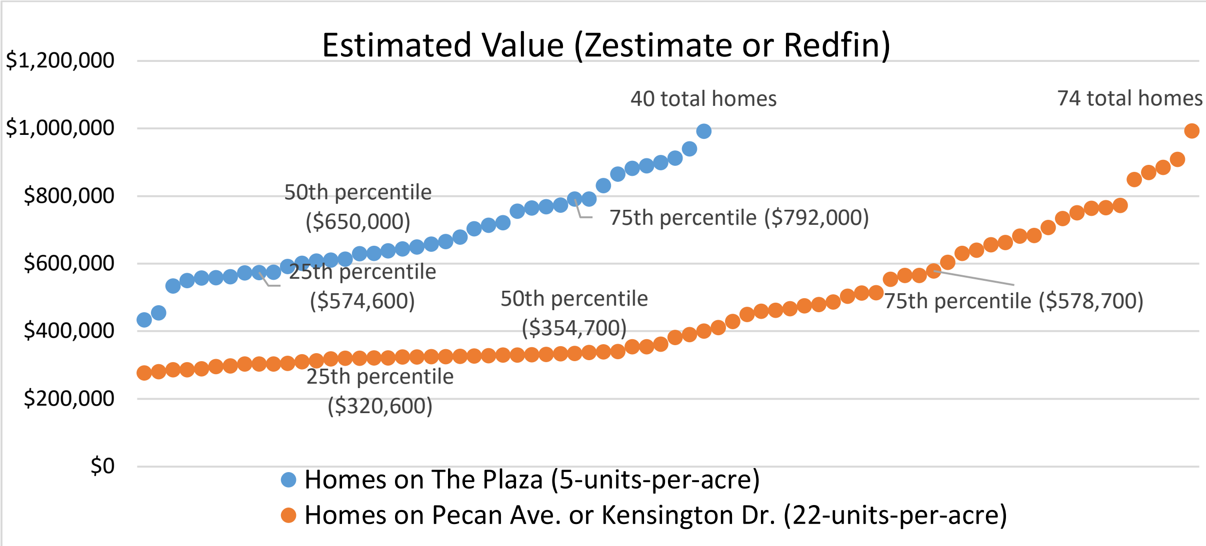
Source: AEI Housing Center

Converting neighborhoods to LTD zoning restores and expands inclusivity because neighborhoods can have various unit types, tenures, and price points in their housing, opening up homeownership opportunities to a wider breadth of buyers. Another example of this process is demonstrated by the Charlotte, North Carolina case study, in which the housing types and socioeconomic backgrounds of people living in two different zoning regimes in the same neighborhood are examined. Both Pecan Avenue and Kensington Drive are zoned for 22 units per acre, or LTD, whereas The Plaza is zoned for 5 units per acre, or SFD.

As a result of the increased density, Pecan and Kensington housing units range from smaller SFD homes on smaller lots to ADUs, duplexes, townhouses, and condominiums. The as-built density for the Pecan and Kensington housing is approximately 11 units per acre, one-half of what is allowed and approximately double the as-built density of The Plaza. The median-priced home on Pecan and Kensington ($354,700) is below the lowest-priced home on The Plaza (approximately $410,000). The most expensive homes on both streets are approximately $1 million, but the least expensive unit on Pecan and Kensington is $277,000. The housing type diversity enabled by LTD allows a greater range of price points, particularly at the middle and low end. There are more housing units at more affordable prices on Pecan and Kensington, with 39 units valued at less than $400,000, making the street ideal for first-time buyers (see Figure 6).

According to U.S. Census Bureau data, a greater share of renters and younger residents live on Pecan Avenue and Kensington Drive which suggests that the increased density increases housing access to a wider range of incomes, particularly younger individuals and families with less financial wherewithal. Generally, these groups are among the first to be priced out of lower-density neighborhoods; however, the R-22 MF zoning restored these streets to the pre-1920s status quo, when LTD was intermixed with SFD homes.

Figure 6: Charlotte: R-22 MF Zoning Offers a Wide Range of Price Points Compared with R5-Zoning



Note: Every dot is a house on Pecan Avenue, Kensington Drive, or The Plaza, ordered by estimated value by Zillow or Redfin.
Sources: AEI Housing Center; Zillow, and Redfin.

The positive effect of more housing supply is reflected in the data on housing prices. AEI Housing Center research finds that a 1-percentage-point increase in total units from 2010 to 2020 was associated with a 10-point decrease in cumulative Home Price Appreciation from 2012 to 2019 in high-employment metropolitan areas.[48] A literature review on the effects of new market-rate housing on rents found that in five out of six studies, this new supply decreased rents for residents across the income spectrum (Pennington, 2021; Phillips, Manville, and Lense, 2021).

How to Implement Light-Touch Density

A "Keep it Simple and Short" (KISS) Approach to Housing

As previously discussed, the economics of housing construction favor moderately higher density and by-right LTD. These policies would allow for higher and better land use, unleashing what Strong Towns calls a "swarm" of property owners, small-scale builders, and local contractors to take on small-scale LTD conversion projects. Evidence from the case studies indicates that small-scale builders, many of whom are disproportionally minority-owned, carry out the majority of these LTD projects. To achieve this result, here are the lessons learned.

What is required?

- By-right approval of LTD housing
- Simple rules regarding the number of units, floor-area ratio, and height restrictions permitted in a given lot.

[48] The results were cross-validated using a regression approach, different construction data sources, and various cut-points of employment growth and time periods. Across these different variations, similar results with slightly different magnitudes emerged.

What helps?

- Relaxing parking requirements (Harrison, 2023)
- Instituting shot clocks, which can accelerate the timelines in slow-moving areas and create more dependable schedules for builders and homeowners attempting to plan for future construction
- Preapproved design standards

What hurts?

- Low maximum floor-area ratio requirements
- High minimum lot size requirements
- Outsized parking or other requirements that increase construction costs or de facto prevent building LTD entirely.
- Income limits and affordable housing fees and mandates
- Rental bans
- Owner-occupancy requirements
- Rent controls.
- Inclusionary zoning
- Impact fees
- Anything not required for single-family homes.

LTD successfully unleashed a swarm of developers in Seattle's LRM zone, in Palisades Park, and in Houston because of the simplicity of the rules, which removed discretionary approval and allowed builders to move forward with projects quickly.

Pro-housing legislators continue trying to ease Senate Bill (S.B.) 9 permitting statewide after the successful passage of S.B. 9 in California, allowing up to four units in areas previously zoned only for single-family homes. A recently introduced S.B. 9 cleanup bill called S.B. 450 would standardize local measures, holding S.B. 9 units to the same codes and design standards as SFD units, simplifying the standards and streamlining S.B. 9 conversations.

California also experienced success with accessory dwelling unit (ADU) legislation in 2016 (S.B. 1069 and Assembly Bill [A.B.] 2299), which made ADU construction by-right, added a 120-day shot clock for cities to approve or deny the project,[49] and eliminated parking requirements near transit while creating a one-per-unit parking maximum elsewhere. Localities have streamlined their permitting processes since California removed restrictions in 2016 regarding building ADUs. For example, as of March 2023, Los Angeles had 66 preapproved ADU designs compatible with neighborhood character, minimizing risks to homeowners and builders because they knew that this design was approved.[50]

As a result, ADU permits increased statewide from 2,000 in 2016 to 19,000 in 2021. In 2021, one in four housing units added in Los Angeles was an ADU, indicating that LTD policies have the potential to affect filtering and affordability greatly.[51] Increasing density through these channels gives renters more options, particularly in resource-rich areas. UC Berkeley research on ADU construction showed that ADU rents in California were naturally affordable to two-person households (Chapple, Ganetsos, and Lopez,

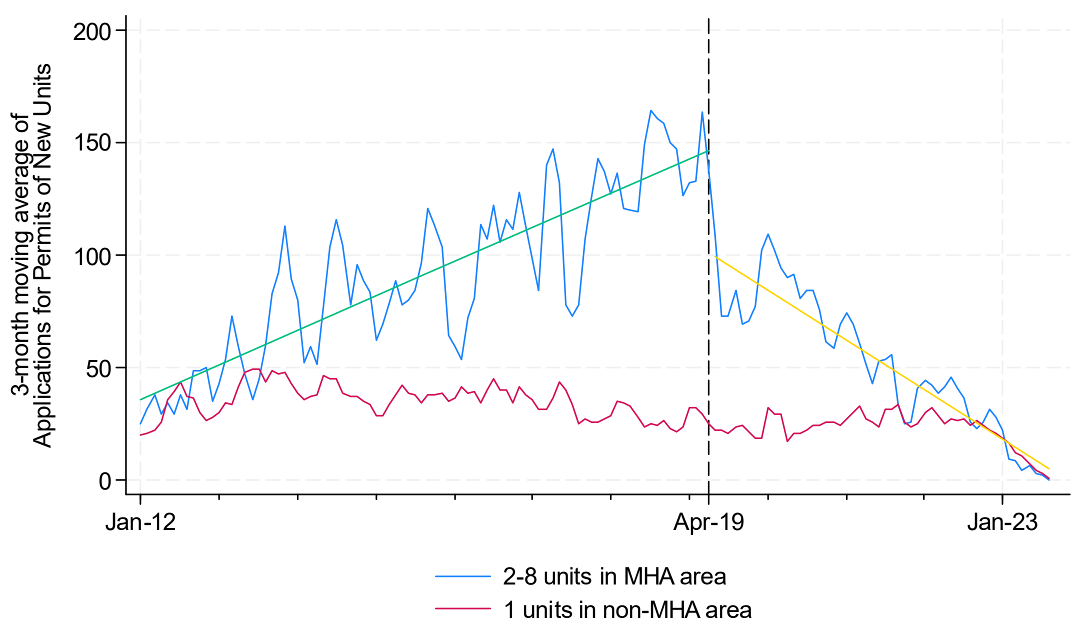
[49] Both Texas and North Carolina passed shot clock bills in 2019 that mandated the review of new housing within 30 days or 15 business days, respectively.
[50] South Bend has a variety of preapproved designs for LTD projects ready for construction.
[51] The Los Angeles City Government created a helpful map on ADU development across the area.

2021). A more holistic pro-housing framework, such as the model LTD bill, would scale this ADU model for duplexes, townhomes, and condominiums across the United States.

On the other hand, although Seattle experienced immense success building thousands of needed townhomes, implementing the Mandatory Housing Affordability (MHA) program in April 2019 attached either income limits or a hefty fine to small-scale townhome projects.[52] The predictable result is that builders have often completely forgone applying for new townhome projects. Whereas permits averaged about 125 units per month in the 2 years before the MHA took effect, they averaged approximately 50 between 2020 and 2022 (Figure 8). This reduction in permitting means that thousands fewer townhomes have and will be built. The restrictions, which are not tied to SFD units, hurt LTD development, and block meaningful pathways to homeownership.

These circuitous affordable housing requirements tilt the scale squarely in favor of professionalized, deep-pocketed firms with attorneys who can make sense of rules that even Seattle officials admit are "large in scope and complex."[53] The result is that small-scale, local, and often demographically diverse developers, contractors, and architects who primarily build LTD units often are left out.

Figure 8. Permit Applications for Seattle Townhome and Single-Family Projects, 2012–23



Sources: City of Seattle and AEI Housing Center

[52] The MHA program attached onerous restrictions for building townhouses and other multifamily housing units—but not single-family detached units—with the goal of creating 6,000 new subsidized housing units through 2025. Builders were given a choice between designating a certain number of units as income-restricted or opting out by paying a hefty fee, yet the sale price of income-restricted units as outlined by MHA largely only covers the cost of the land without any structure cost. Paying the fee is not much better. A recent survey by the Master Builders Association of King and Snohomish Counties finds that the upfront fee can be as high as $130,000 for an average four-unit townhome project. Often, neither option is financially feasible.

[53] https://seattle.gov/Documents/Departments/HALA/Policy/Directors_Report_MHA_Citywide.pdf

The Colorado LTD bill, S.B. 23-213[54]—which ultimately failed—emphasized “developing a menu of affordability strategies,” or implementing income-based subsidies and income restrictions that have already worsened affordability woes. California’s A.B. 68, which expands by-right zoning in walkable-oriented development areas, also has affordability requirements. Adding such requirements creates complexity and renders many projects infeasible because builders cannot profit. As demonstrated in Seattle, these costly requirements can be the death knell for small-scale development projects.

No study examining the impact of Inclusionary Zoning (IZ) has concluded that it expands housing supply or “contributes to broadly lower prices (Hamilton, 2021).” One study focusing on the impact of various policies on housing affordability asks, “Can relaxed IZ substitute for land-use regulations?” and concludes that, on the whole, no (Kulka, Sood, and Chiumenti, 2022). Work by the Manhattan Institute finds that IZ drives up market rents, reduces housing construction, and negatively affects the overall health of the housing market (Harris, 2021). The California Legislative Analyst’s Office (LAO) found that displacement was lowest in communities that built more housing, and that the relationship was not dependent on inclusionary zoning regimes (Taylor, 2016).

In other cases, such as in Oahu, Hawaii, regulations legally allow duplexes but make them practically impossible to build, hindering LTD development. Although both a duplex and a detached two-family dwelling are allowed in R-3.5, R-5, and R-7.5 zones in Oahu, any parcel with a two-family dwelling requires significantly more land than a detached single-family dwelling, making these types of structures practically not buildable in these residential zones (See Table 2).[55] As a result, few-to-no LTD-style units are built, perpetuating the reliance on SFD units that are not naturally affordable to many Oahu residents.

Table 2: Oahu’s Residential Districts Development Standards

Development Standard		District				
		R-3.5	**R-5**	**R-7.5**	**R-10**	**R-20**
Minimum lot area (square feet)	**One-family dwelling, detached, and other uses**	3,500	5,000	7,500	10,000	20,000
	Two-family dwelling, detached	7,000	7,500	14,000	Use not permitted	Use not permitted
	Duplex	3,500	3,750	7,000	Use not permitted	Use not permitted
Minimum lot width and depth (feet)		30 per duplex unit, 50 for other uses		35 per duplex unit, 65 for other uses	65 for dwellings, 100 for other uses	100
Yards (feet):	**Front**	10 for dwellings, 30 for other uses				
	Side and rear	5 for dwellings[1], 15 for other uses			5 for dwellings, 15 for other uses	
Maximum building area		50 percent of the zoning lot				
Maximum height (feet)[2]		25-30				
Height setbacks		per Sec. 21-3.70-1(c)				

[1] For duplex lots, 5 feet for any portion of any structure not located on the common property line; the required side yard is zero feet for that portion of the lot containing the common wall.
[2] Heights above the minima of the given range may require height setbacks or may be subject to other requirements. See the appropriate section for the zoning district for additional development standards concerning height.
(Added by Ord. 99-12)

Sources: Oahu City Government; AEI Housing Center

[54] https://leg.colorado.gov/bills/sb23-213
[55] For example, in R-7.5, the median lot square footage is approximately 7,500 square feet, yet a duplex (two units) or a two-family dwelling effectively requires 14,000 square feet.

LTD is the common denominator in zoning reform and has received widespread support. However, the devil is in the details. Following the "Keep It Simple and Short" (KISS) rule can unleash the potential of LTD.

Housing bills with more strings attached often fail in state legislatures. Gubernatorial-supported bills in New York and Colorado failed to garner support for proposed sweeping housing reforms that included elements of LTD because the wide-reaching nature of the bills ostracized potential supporters and galvanized detractors. In 2019, pro-housing California legislators proposed a transit-oriented development (TOD) measure called S.B. 50[56], which permitted high-density buildings near transit; it ultimately failed in the State Senate. California Yes In My Backyard (YIMBY) chief executive Brian Hanlon said, "S.B. 50 was a big bill that had something for everyone but also something for everyone to hate."[57]

By contrast, in 2021, California passed two LTD bills: S.B. 9 and S.B. 10.[58] As the *New York Times* summarized, "in housing legislation, smaller is better." These LTD units are built more gradually while being compatible with residential neighborhoods relative to TOD and have the potential to make a meaningful dent in the housing affordability crisis. California shows that LTD, not TOD, represents the winning formula.[59]

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[56] https://cayimby.org/sb-50/

[57] See *The New York Times* article, "After Years of Failure, California Lawmakers Pave the Way for More Housing." https://www.nytimes.com/2021/08/26/business/california-duplex-senate-bill-9.html

[58] S.B. 9 allows for up to two to four units of housing in most areas previously zoned exclusively for single-family homes. Homeowners can add a second unit on their lot, split their lot and sell that land to another family, or build two units per lot by-right. Under S.B. 10, cities can choose to authorize construction of up to 10 units on a single parcel without requiring an environmental review, at a height specified in the ordinance, if the parcel is in a transit-rich area or urban infill site.

[59] As of March 2023, California has an S.B. 9 cleanup bill, S.B. 450, on its docket, which would ensure that S.B. 9 standards are the same as for new SFD developments and that applications be approved or denied within 60 days. These changes would restrict bad-faith local government actions taken to constrain S.B. 9 developments. S.B. 450 built upon previous ADU cleanup bills passed by the California legislature in 2016 that similarly incorporated LTD concepts.

Appendix 2:

Seventy years after the Housing Act of 1949, we are considering spending $40 billion or more to try to get public housing right. But consider these observations made in 1954 by housing leaders of the National Association of Home Builders:

> There are outstanding examples … of federal programs that have hampered home building. The most glaring is public housing, subsidized at the expense of the taxpayer, yet normally failing to meet the needs or services of the community as well as they could be met through private industry…. Public housing is not low-cost housing. It is high-cost housing offered at low rent. And the low rent is possible only because of government subsidies charged to all taxpayers…. The initial construction cost of public housing projects, however, is not the worst cost…. [There] is an operational subsidy of nearly $19,000 per apartment, which cost $11,000 to build.[60]

Fifty years have passed since the passage of the Housing and Community Development Act of 1968, the last time Congress provided subsidies to build or rehabilitate millions of homes. Today there are proposals to spend "five times in inflation-adjusted dollars than Congress authorized in the seminal Housing and Urban Development Act of 1968 to develop new affordable housing following widespread riots in the wake of Martin Luther King's assassination."[61] This 1973 book's title sums up devastation that followed the 1968 Act: *Cities Destroyed for Cash: The FHA Scandal at HUD.*[62]

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[60] *Housing ... U.S.A. : as industry leaders see it*, 1954, https://catalog.princeton.edu/catalog/SCSB-3002043

[61] *How Biden hopes to fix the thorniest problem in housing*, Politico, April 10, 2021, https://www.politico.com/news/2021/04/10/biden-housing-plan-480676#

[62] For example, the 1968 Act contributed to unprecedented levels of FHA foreclosures as documented in Boyer's *Cities Destroyed for Cash: The FHA Scandal at HUD* (1973).

Appendix 3:

Vilifying institutional landlords and other entities distracts from the underlying issues facing the housing market.

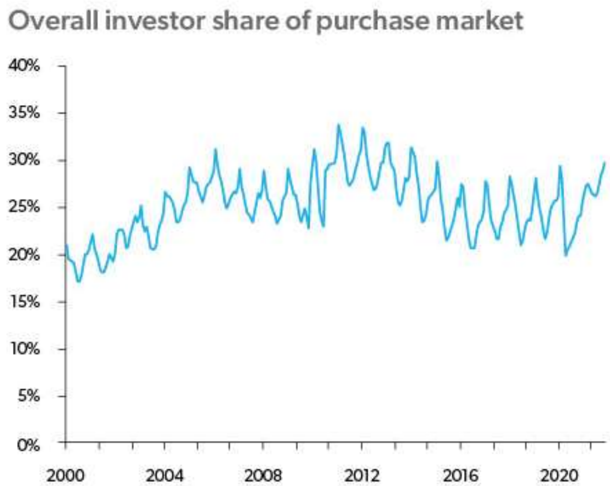
Take institutional investors for example: These landlords are a symptom of the housing boom and bust cycle created by the government, rather than the cause for today's unaffordability.

Institutional landlords, particularly on the multifamily side, are taking advantage of more liberal credit terms provided by Fannie Mae and Freddie Mac (the GSEs) than the private sector, which is a violation of their Charters, which stipulate that they shall adhere to the same lending standards as imposed by the private sector with the objective of purchasing loans "at such prices and on such terms as will reasonably prevent excessive use of the corporation's facilities."[63] They use their taxpayer guarantee and other advantages to greatly expand their business, while crowding out multifamily private investors. Since 2014 outstanding multifamily mortgage debt has doubled, with the GSEs accounting for most of the growth. At the same time they tout that they are supporting affordable rental housing, but in reality they create government profit seeking.

On the single-family side, they account for too small a share of purchases and of the housing stock nationally (according to Freddie Mac, they account for around 2.5% of the purchase market, with the largest share being so-called mom-and-pop investors). Even in the few metros where their share is higher, it is not enough to move the price needle, especially at the low end of the market.

HousingWire's Logan Mohtashami citing numbers from John Burns Real Estate states that "The viral story saying Wall Street has bought 44% of the single-family homes this year is laughable. The 1000-plus block buyers accounted for just 0.4% of market share in [2023:]Q2".

[63] For example, Fannie Mae charter stipulates that "… the operations of the corporation under this section shall be confined so far as practicable, to mortgages which are deemed by the corporation to be of such quality, type, and class as to meet, generally, the purchase standards imposed by private institutional mortgage investors. In the interest of assuring sound operation, the prices to be paid by the corporation for mortgages purchased in its secondary market operations under this section, should be established, from time to time, within the range of market prices for the particular class of mortgages involved, as determined by the corporation. The volume of the corporation's purchases and sales, and the establishment of the purchase prices, sale prices, and charges or fees, in its secondary market operations under this section, should be determined by the corporation from time to time, and such determinations should be consistent with the objectives that such purchases and sales should be effected only at such prices and on such terms as will reasonably prevent excessive use of the corporation's facilities,…" (Fannie Mae's Charter (12 U.S.C. 1719)).



Source: Freddie Mac Economics & Housing Research estimates based on public records data. Small investor = 1-9 properties, Mid-sized = 10-99 properties, and Institutional = 100+ properties purchased in the past 12 months. We identify second homes via mortgage riders in Black Knight data, so we miss all-cash second home purchases.

Source: Freddie Mac Economics & Housing Research estimates based on public records data. Small investor = 1-9 properties, Mid-sized = 10-99 properties, and Institutional = 100+ properties purchased in the past 12 months. We identify second homes via mortgage riders in Black Knight data, so we miss all-cash second home purchases.

Or take short-term rentals (STR) such as AirBnB:

While there is some evidence that suggests that STRs contribute to slightly higher rents, the example of Hawaii, where home prices and rents have been far above the national average since at least the 1980s, disproves that they are the main contributor. In Hawaii, high prices and rents far predate the rise of STRs, which gained a hold in the early 2010s. Data from insideairbnb show that infrequently booked STRs earn about $5,500 per year. At a rate of about $300-500 per night, that means that these listings are used about 10-20 days of the year. If most STRs are infrequently booked, then it would also suggest that someone else is living in these homes for the rest of the year and it therefore seems unlikely that banning STRs would meaningfully increase the supply of housing.

The housing market is becoming less affordable, not because of institutional landlords, STRs, or other private entities, but due to misguided federal policies.

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Op-ed on 12/10/23 in The Hill.

New York City officials blame everyone but themselves for housing unaffordability

By implementing onerous requirements on Airbnb hosts, New York City is attempting to scapegoat short-term rental (STR) sites for the city's own failings. Rather than accounting for city policies that continue to drive its housing and hotel room shortage, officials have decided to target the city's 40,000 active listings, operated by—mostly smalltime-- Airbnb hosts. In the end, the city will get neither the housing affordability nor housing supply it purports to be seeking, but it has handed yet another political win to the hotel workers' unions.

While the city has followed the examples of Dallas, Philadelphia, New Orleans, Los Angeles, and Boston, the backstory to the passage of NYC's STR law, which requires STR hosts to register with the city and to be present during the guest's stay, is particularly egregious.

Consider that in 2010, the city, at the behest of the hotel workers' union, began its assault on hotels. The goal was to limit the construction of new, generally nonunion, hotels, to increase hotel room prices, which would particularly bolster higher-end union hotels. The city first banned and closed 55 youth hostels, before later imposing stringent requirements on building new hotels. Even the city predicted a hotel room shortage, and indeed not a single hotel permit has been issued since.

While the union certainly got its way with the city, it did not foresee the ingenuity of the free market. Once hotel rooms became scarce, STRs, with no union workers, started to fill the void. The hotel union needed to avoid the fate of NYC cabs, which had been dealt a near-fatal blow by the emergence of ride-sharing apps such as Uber and Lyft. Remember when in 2013 NYC taxi medallions were worth as much as $1 million? Today, they sell for about a tenth.

It should come as no surprise that the hotel unions, true to form, would be the driving force behind the STR crackdown. After all, the roughly 40,000 STR residential listings may only represent 1% of NYC's total housing stock – too small to have a significant impact on housing affordability (as studies have shown) – but they present a significant threat to the city's roughly 120,000 hotel rooms.

In its quest to rein in STRs, the union's effort was assisted by citizens concerned about loud noises and other disturbances from STRs, which supposedly justified sweeping action. If true, these legitimate concerns could and should be dealt with through nuisance laws, rather than outright bans. After all, homes are private, not communal, property.

However, elected officials were once again happy to do the bidding of the union and NIMBYs by falsely adopting housing affordability as the rallying cry. Of course, the inconvenient truth is that housing in high-cost places such as NYC was unaffordable long before STRs emerged about 15 years ago. Furthermore, housing cost rose 25-30% in the New York metropolitan area since the onset of the pandemic, while STR listings fell by about half.

The ban will also not free up many units. Most STR hosts share their homes infrequently, rather than full-time. On average, NYC's STR listings were rented out for 19 days and provided about $2,200 of income per year. It used to be that cash-strapped residents could turn to STRs for a modicum of supplemental income. No more. Preliminary data indicate that after the ban, STR listings have dropped by almost 80% in New York City, boosting the profits of the city's hotels, which already charge among the highest rates in the country.

While NYC's sledgehammer approach may play well with local unions and NIMBYs, in reality, the root cause for housing unaffordability is government regulatory failure. Home prices and rents are high because state and local laws have prevented more supply from being built while federal lending and monetary policies have juiced demand for this inadequate supply.

Ironically, it was NYC that pioneered the nation's first zoning law. Today, its zoning regime has morphed into a bureaucratic monstrosity: the names of the various zoning districts alone run 16 pages long, the residential district regulations 283 pages, and the entire document 3448 pages. It is easy to see why building new housing has become so complex, costly, and rare. But rather than repeal laws that shackle the market, NYC's bureaucrats now want to bribe 55 homeowners with $400,000 each to build tiny houses in their backyard – as if that would make any difference.

The example of NYC's STR ban shows that the laws of supply, demand, and unintended consequences cannot be ignored. Yet, city officials in many places will embrace every opportunity to divert attention from their own policy failures by doubling down on yet more market distortions. Instead, the path to affordability and prosperity for all starts by cutting red tape and unleashing the free market system.

Mr. Peter is an American Enterprise Institute senior fellow and co-director of the AEI Housing Center.

Appendix 4:

Op-ed on 1/4/2024 in The Hill.

To fix their housing shortage in 2024, cities and states should turn to market rather than heavy-handed regulatory solutions

States and cities considering housing supply reforms in the new year to combat worsening affordability should unleash the free market rather than rely on the Department for Housing and Urban Development (HUD) regulatory solutions. HUD's recommendations tilt towards heavy-handed government interventions that lack thorough analysis and proven results.

A particularly egregious example is HUD's latest assessment of Seattle's Mandatory Housing Affordability (MHA) fund, which looks past historical context and unintended consequences while presenting a one-sided picture. While HUD singles out the "success" of the MHA by highlighting the creation of hundreds of new affordable units since its inception in 2019, it leaves out the thousands of units that were not built because of MHA. In that sense, the MHA has undone decades of progress from Seattle's prior upzoning reforms that freed the market from government regulations.

To properly evaluate the MHA, one must go further back in time than the HUD assessment. The story begins in the mid-1990s when Seattle started to grapple with rising housing costs. As a political compromise that left most of the city restricted to single-family zoning, the city allowed moderately higher density around "urban villages" that comprised only about 16% of the city's residentially zoned land. The idea was simple: Increase supply within the urban villages by replacing older single-family detached residences with new generally four-unit townhomes.

The results were telling: Over the following two decades, mostly small-scale builders constructed 18,000 new townhomes – just imagine the potential had this policy been applied more broadly. While the new units were market-rate, they greatly expanded opportunities for homeownership and wealth building: From 2012-2020, 42% of townhome buyers had moderate incomes. Crucially, these new homes freed up older homes to those of more modest means through a process known as filtering.

Against this backdrop, Seattle's bureaucrats snatched defeat from the jaws of victory and decided that they could provide even more affordable housing than the market. They settled on a carrot and stick approach through the MHA. In exchange for moderately higher density, builders could either designate a certain number of units as income–restricted or opt out by paying a hefty fee. The city would then use the fee to fund affordable housing elsewhere.

The results, however, have been underwhelming. While it is true that the MHA has generated additional funds, it has not generated "a significant number of affordable housing units" as HUD claimed. Rather, the MHA has funded only a total of 1,178 affordable units over 4 years. At this pace, Seattle is on track to add about 3,000 affordable housing units over the next decade, far short of its goal of 20,000 affordable units and the at least 15,000 townhomes the market was on pace to build.

Even more telling is that, because of the MHA, Seattle is now building fewer housing units than before – although this is ignored by HUD. Multiple studies found major declines in permit activity over the four years following the implementation of MHA, which may have cost the city between 3,200 to 9,000 new units.

Fewer housing units also mean higher housing pressures for Seattle residents. Sure, there will be a few lucky ones that will live in the new affordable units, but primarily lower- and middle-income households will bear the brunt. Housing costs will rise and there will also be far fewer opportunities for homeownership and intergenerational wealth-building. By the end of 2022, MHA had only funded 30 for-sale condominiums.

But that is not all. Compared to large firms with big staff, small firms that primarily build townhomes cannot navigate the rules that the city admits are "large in scope and complex." But the alternative of paying the MHA fee is not much better. A survey by the Master Builders Association of King and Snohomish Counties finds that for an average four-unit townhome project the up-front fee can be as high as $130,000. No wonder that small-scale, local, and often demographically diverse builders are closing.

The case of Seattle offers two lessons: Implementing an affordability mandate was an utter failure, while allowing moderately higher density without strings attached was a clear success that should be expanded to more areas of the city. Seattle also offers a warning to those pondering the appropriate role of the federal government in state and local housing reform: It confirms that HUD's distrust of market forces clouds its assessment of regulatory best practices. These efforts are better left to the competition of ideas and the laboratories of democracy.

As more states and cities contemplate housing regulatory reforms in 2024, let's hope they follow the evidence, rather than HUD's flawed recommendations.

Mr. Peter is an American Enterprise Institute senior fellow and co-director of the AEI Housing Center.

Appendix 5:

Federal housing policies have created more demand against a limited supply, which has pushed up home prices.

- Foreclosure-prone affordable housing policies began in 1954, when Congress authorized FHA to use the 30-year loan and have been primarily targeted at low-income and minority borrowers.
    - These policies have subsidized debt by providing excessive leverage.
    - Coupled with the supply shortage, the increased demand from additional leverage has fueled unsustainable lending and higher home prices.
    - This is the paradox of accessible lending: When supply is constrained, credit easing will make entry-level homes less affordable.
    - During the Financial Crisis, these policies contributed to 12 million foreclosures and other forced dispositions, which were proportionally higher in low-income and minority neighborhoods.
        - The foreclosure rate of 27% in low-income census tracts (defined as <80% of area median income) was 1.5 times as high as the 18% foreclosure rate in high-income census tracts (defined as ≥120% of area median income).
        - The foreclosure rate of 30% in census tracts with a Black and/or Hispanic share of households of at least 50% was twice as high as the 16% foreclosure rate in census tracts with a Black and/or Hispanic share of households of less than 10%.
    - These policies have not built generational wealth and despite the government's efforts over the last 60 years, homeownership today stands at about the same level as in 1964.
    - Furthermore, Housing finance policy is on autopilot, creating harmful market distortions while failing to deliver meaningful results.
        - The GSEs continue to dominate lending with about 50% market share, with total government involvement at about 80%. This is not allowing the private sector to gain more than a foothold, much less grow.
        - GSE subsidies are not well targeted to helping low- and moderate-income, first-time buyers. The lion's share of the benefit is going to existing middle- and increasingly upper income homeowners, as evidenced by conforming loan limits of almost $1 million used by the GSEs.

Due to the legacies of the federal government's promotion of racially biased zoning and its support for risky high-leverage mortgage loans, low-income homebuyers have been subjected to the inflationary effects of dangerous leverage and extremely low interest rates.

We have examined one of these leverage policies, FHA's mortgage insurance premium cut from 2015 in greater detail. At the time, the FHA claimed that the premium drop would result in 250,000 new first-time buyers over the next three years, and save each FHA buyer $900 annually. In research by the AEI Housing Center, we along with our colleagues found that home prices went up by about 2.5% for FHA borrowers. These borrowers had to use part their newfound "wealth" — obtained by paying lower FHA insurance premiums —to pay for the higher house price.[64]

[64] Davis, Oliner, Peter, and Pinto, *The impact of federal housing policy on housing demand and homeownership: Evidence from a quasi-experiment*, http://www.aei.org/wp-content/uploads/2018/01/Oliner-homeownership-WP-Update.pdf?x91208

Prices also went up for non-FHA buyers in neighborhoods with FHA insured sales. After all, it is one housing market, where borrowers, no matter the financing, compete for houses. This caused the non-FHA buyers, who did not receive the benefit of lower premiums, to largely offset the price increase by buying a home of lesser quality (perhaps a smaller home, a smaller lot, or in a different location) – they were the clear losers.

We estimate that about 500,000 of these non-FHA borrowers were first-time homebuyers. Each of these non-FHA homebuyers paid approximately $6,200 extra per house, a total extra payment of about $3.1 billion. From a cost-benefit perspective, this averages to an incredible $180,000 for each of the roughly 17,000 new FHA first-time buyers!

The big winners were the realtors who received hundreds of millions of dollars in higher commissions from higher prices. Little wonder the National Association of Realtors lobbied heavily for the cut in 2015. The increase in commissions from the 2015 cut averaged about $325 per sale. If you multiply that by over 1.22 million home sales in tracts with high FHA concentration in 2015, you get a windfall of almost $400 million per year—not a bad return on the tiny fraction spent on lobbying.

Economic principles, ironically first described by Ernest Fisher, the FHA's first chief economist in the 1930s, gave us reasons to be doubtful of the FHA's predictions: liberalizing credit when the inventory of homes for sale is tight fails to bring in a lot of new buyers, and increased buying power in a sellers' market drives prices higher as buyers compete over a limited supply of houses. In 2015, the FHA ignored the fact that the nation was already two and one-half years into a seller's market — defined by the National Association of Realtors (NAR) as a market with less than a six month supply of homes for sale at the current selling pace.

We also found that even though FHA's loan volume increased substantially in the first year after the 2015 premium cut, only about 17,000 were new first-time buyers, far short of FHA's prediction. The rest were borrowers poached from other federal agencies or buyers who purchased homes unrelated to the premium drop.

Despite the damning evidence, the FHA undertook another MIP cut in 2023 during an even more constrained housing market.

Furthermore, the administration has implemented or is considering a plethora of far-reaching changes to the housing finance system that will reshape housing finance and that will have many unintended consequences. Examples include:

March 2023: FHFA announces mortgage pricing changes, which have generally decreased fees for borrowers with lower credit scores and increased fees for those with higher scores.

Missed in the debate about loan-level pricing adjustment (LLPAs) changes is that the Federal Housing Finance Agency already distorts the riskiness of loans it originates, and ultimately taxpayers are on the hook for those loans. Every year the FHFA shuffles up to $6 billion from higher- to lower-quality borrowers. The recent changes are another progression in a series of steps under Director Sandra Thompson that have hollowed out the risk-based pricing structure erected after the 2008 financial crisis.

March 2023: FHFA announces deferral available to all borrowers with "eligible hardships."

“Eligible hardships” was conveniently not defined. Neither does it state how many times a borrower could take advantage of this option. While some argue that this policy worked well during the pandemic and prevented many foreclosures, it isn’t that simple. Borrowers who received forbearance also could have benefited from expanded unemployment coverage, the Paycheck Protection Program, student-loan payment waivers, other Covid benefits and the quick recovery from the economic contraction.

<u>May & December 2023:</u> FHA solicits comments on Payment Supplement Partial Claim.

Under the current proposal, our concerns are that a borrower becomes eligible simply by falling behind on their payments, with no requirement to demonstrate hardship. There is no friction in the process as the mortgagee is obligated to initiate the process started, without the borrower even requesting it. A borrower can re-up the Payment Supplement Partial Claim multiple times as long as sufficient Partial Claim funds are available. A borrower may claim the Partial Claim for up to 60 months (later revised to 36 months). After 36 months he or she is then eligible for another Partial Claim. While borrowers are no longer able to enter into serial Payment Supplement, they can still claim it for 3 out of 5 years and start over until funds run out.

Simply by not paying the mortgagee, a borrower can set him or herself up for up to 36 months of significantly reduced payments without having to put in any effort in receiving the assistance because he or she gets automatically notified from their mortgagee. No income documentation is required to determine the borrower's Payment Supplement Partial Claim. A borrower receiving the benefit of a Partial Claim is provided an interest-free loan of 25% of their P&I for each month for the next 3 years. This policy is fraught with moral hazard both by mortgagors and mortgagees.

<u>July 2021:</u> House bill introduced to eliminating the use of credit scores in mortgage underwriting or create a government credit repository.

Some already have labeled credit scores racist. While these scores are predictive of defaults, they also represent an enormous hurdle to expanding credit to underserved communities, whose members typically have lower scores and thus require risk premiums. Doing away with credit scores would have unintended consequences, particularly for lower-income Americans, by raising the cost of credit for them.

<u>June 2023</u>: Recommendations of the PAVE working group on how to address racial bias in home valuations.

While, we agree that the appraisal industry needs to change, PAVE’s recommendations came up short because they do not 1) identify and address the root causes of the industry’s problems, 2) identify and address in a timely and comprehensive manner appraiser racial and ethnic bias and inaccuracies, and 3) avoid overreach and damaging unintended consequences.

<u>May 2023:</u> House and Senate bills introduced to lower underwriting standards for first respondents or teachers (HELPER Act).

While it is estimated that anywhere between 400,000 to 1 million Americans may qualify for the benefit, the more pressing question is where the required homes would come from. Studies have estimated that the country has a shortage of around 3.8 million to 20 million homes.

June 2023: The Downpayment Toward Equity Act of 2023 is introduced in the House.

Bill would provide up to $25,000 cash grant for first-generation home buyers, which would get capitalized into higher home prices during the current seller's market.

2022 and 2023: Fannie Mae and Freddie Mac introduce and expand Special Purpose Credit Programs (SPCP).

The programs lower underwriting standards in minority census tracts, thus expanding leverage in a seller's market, which is most severe at lower price points. These efforts could result in greater home price appreciation and crowding out of lower-income people.

February 2023: FHA reduces its mortgage insurance premium.

FHA's 30 bps mortgage insurance premium (MIP) cut will expose taxpayers and not help prospective homebuyers. Rather than cutting the premium on 30-year loans, there are good reasons why FHA should have held on to its reserves. Given the current economic uncertainty, which could mean layoffs and delinquent FHA borrowers depleting their financial reserves. Given this uncertainty, FHA should keep its powder dry. For one, home prices are still at inflated levels due to the Fed's loose monetary stimulus. Moreover, while the market has strongly corrected in markets such as San Francisco or Seattle, home prices can still decline further, which would spell trouble for FHA borrowers.

September 2021: Fannie started to include rental payment history in its risk assessment processes, which increases demand for housing without addressing supply.

August 2021: FHFA proposes and subsequently passes new benchmark level for minority & low-income tracts home purchase in 2022-24.

FHFA proposed to raise the Low-Income Home Purchase Goals affordable housing goals for low-income 2022-2024 to 28%, up from the current 24% level. The risk of this approach becomes obvious when compared to the period before the last financial crisis when the affordable housing goals were last raised.

From 1996 to 2008, the Special Affordable Housing Goals for purchase loans were raised from 12% to 27%. At the same time, the GSE purchase stressed default rate increased from 11.7% to 21.5% in 2007, before lending standards were significantly tightened. The tight correlation between both lines becomes evident in the chart below.

Due to the ever-increasing Affordable Housing Goals, the GSEs were forced to lower their underwriting criteria in order to fulfill those goals. The result, of course, was a massive build-up of risk, which eventually ended in 12 million foreclosures and other forced dispositions, which were proportionally higher in low-income and minority neighborhoods.

By historical standards today's GSE mortgage risk looks fairly benign, but FHA's mortgage risk is about at the same level as in 2006. These loans are highly geographically concentrated and the GSEs will be forced to compete with FHA when the goals are raised.

Ongoing:

1) According to the AEI Student Debt Forgiveness Tracker, the administration has already forgiven $317 bn student loan debt during an overheated housing market, which would increase first-time buyer buying power and increase demand, which would result in higher home prices.[65]

2) Foreclosures: After the experience of the Great Financial Crisis and the foreclosure moratorium of the pandemic, it appears that the administration is intent on making foreclosures as burdensome as possible for servicers. While this will certainly lead to unintended consequences, once achieved, progressives would point to low rates of foreclosures as evidence that the credit box can be expanded further.

   Research from at least one think tank is pushing for looser underwriting relating to the Three Cs of Mortgage Credit (Credit, Capacity, and Collateral) under the guise of "closing the homeownership gap" and "rooting systemic racism out of mortgage underwriting". The proposed policies largely mirror similar 1999 research by the same think tank to loosen the Three Cs lending standards. That research was funded by HUD and had devastating results.[66] Others, like the Underserved Mortgage Markets Coalition would push the GSEs into riskier loan types, and looser underwriting.[67]

   Ultimately, a mortgage finance system without payments, the threat of foreclosure or proper underwriting standards is ultimately an entitlement program. If such a program were established, it would be here to stay—and would most likely grow.

What progressives fail to understand is that access to credit isn't the root cause holding back Americans, particularly those of color, from owning a home. Notwithstanding numerous attempts and enormous spending by the federal government, the black homeownership rate today is barely higher than in the 1970s. Instead, the U.S. is undersupplied by millions of homes, which makes buying a home more difficult. In addition, there are far-reaching shortcomings in educational outcomes, marital status and

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65 https://www.aei.org/studentdebtforgivenesstracker/

66 For 2022, see" https://www.urban.org/urban-wire/closing-homeownership-gap-will-require-rooting-systemic-racism-out-mortgage-underwriting. In April 1999 the Urban Institute released a report commissioned by HUD two years earlier. The report, entitled "A Study of the GSEs' Single-Family Underwriting Guidelines"[1] advised: "Almost all the informants said their opinion of the GSEs has changed for the better since both Fannie Mae and Freddie Mac made substantive alterations to their guidelines and developed new affordable loan products with more flexible underwriting guidelines." … "Informants did express concerns about some of the GSEs' practices. The GSEs' guidelines, designed to identify creditworthy applicants, are more likely to disqualify borrowers with low incomes, limited wealth, and poor credit histories; applicants with these characteristics are disproportionately minorities." By 2000, the GSEs had largely done away with down payments, raised debt ratios, entered the "A-minus" and "B" subprime market and re-entered the low doc/no doc market. http://www.urban.org/publications/1000205.html

67 Policies advocated include a "substantially increase the number of purchased mortgage loans secured by manufactured real property," that "Fannie and Freddie should revive their plans to begin to purchase chattel loans", "offering exceptions for the income limits in the HNRRs," "targeted use of credit exceptions," "instituting a 4% deferred second mortgage to cover closing costs and boosting the seller concession from 3% to 6%," or that the "GSEs eliminate their loan-to-value limits to better align with FHA rules." See https://www.insidemortgagefinance.com/articles/223669-nonprofit-coalition-offers-blueprint-to-improve-fanniefreddie-dts-plans?v=preview.

earnings that need to be addressed. These socioeconomic factors explain most of the gap in homeownership between black and white Americans.

The administration's recent actions to expand homeownership to underserved communities are both flawed and reminiscent of similar failed efforts, particularly those made in the runup to the 2008 financial crisis. Remember when in 1994 Fannie Mae committed to "transforming the nation's housing finance system to make it accessible to everyone"? To quote Yogi Berra, "It's like déjà vu all over again."

Each one of these above mentioned programs on its own seems innocuous. However, the accumulation and combination of them should raise alarms. With new leadership at federal agencies and regulators, a concerted effort to lower underwriting standards again – as happened during the 1990s and 2000s – seems to be underway.

Raising the Affordable Housing Goals requires lessening criteria on risk layering, otherwise the goals could not achieve much. At the same time, the effort to bring in higher-risk borrowers requires larger cross-subsidies, which required changes to the LLPAs. While lower-income Americans are being crowded out of the housing market, bringing them back by lowering underwriting standards through a concerted efforts by federal agencies and regulators is a recipe for disaster and risks creating more housing risk. This will put the exact people the policies are intended to help into harm's way.

<u>Appendix 6:</u>

While the outcomes for the housing market are outlined below, easy money also had effects on inflation.

- Just since the beginning of the pandemic, the Fed's monetary policies have contributed over $1 trillion in wealth effects available to be used for additional spending.[68]
- Researchers at the Dallas Fed have found a "high correlations between current house price growth and future inflation of rent and [owners'-equivalent rent] OER" and predict rent and OER inflation to reach 6-7% by 2023, up from around 2% today.[69]

Thus, higher inflation was foreseeable and we started to warn as early as July 2020 of an impending housing boom and indicia of higher price levels ahead.[70]

The effects of the coronavirus pandemic were unprecedented in terms of widespread lockdowns, skyrocketing unemployment, and a financial market crash. The Federal Reserve took aggressive expansionary efforts in the form of zero interest rate policy (ZIRP) and quantitative easing (QE) to stabilize the economy, while Congress enacted massive fiscal stimulus. However, one of the results was a runaway home price boom.

It is now generally acknowledged that the Federal Reserve ended up overshooting by not recalibrating its policies in light of both overwhelming fiscal and housing market responses. Both of these fueled an explosion in aggregate demand, especially for goods and houses.

By the end of August 2020, near-real-time credit card data indicated that sales for July 2020 were up 2% on a year-over-year basis, indicating a recovery from the initial pandemic shock. By mid-December 2020, these same data indicated that sales for late October 2020 to late November 2020 were up 6% on a year-over-year basis, signaling a policy-induced acceleration of demand. Spending in the lowest two quintiles of zip codes by income was growing at 13% and 9% year-over-year, reflecting the especially large fiscal stimulus for lower-income households.[71]

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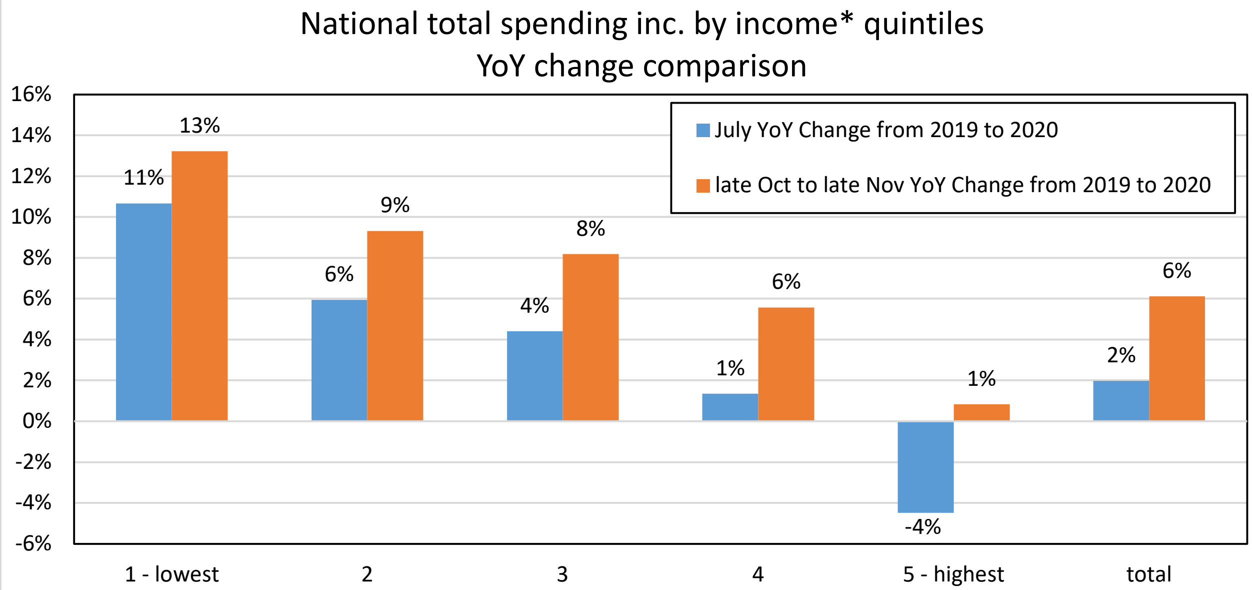
[68] About $420 billion ($15 trillion in stock market valuation increase since end of 2019 x 2.8 cents per year in increased consumption), about $180 billion (home equity gains over the last 18 months yields an average $2,200 per household in additional consumption spending over the next couple years, or about $180 billion of additional spending summed up across all homeowners, about $280 billion/year from monthly payment savings on Rate and term refinances, and about 90 billion/year from equity extraction on cash out refinance loans. CITE CONFERENCE

[69] https://www.dallasfed.org/research/economics/2021/0824

[70] For the entire paper, see https://www.aei.org/research-products/report/the-federal-reserves-housing-market-lessons-to-be-learned-once-again/

[71] In addition, stock and home prices were booming by late 2020. The ensuing wealth effect, which develops with a lag, should have been well known to the Fed.



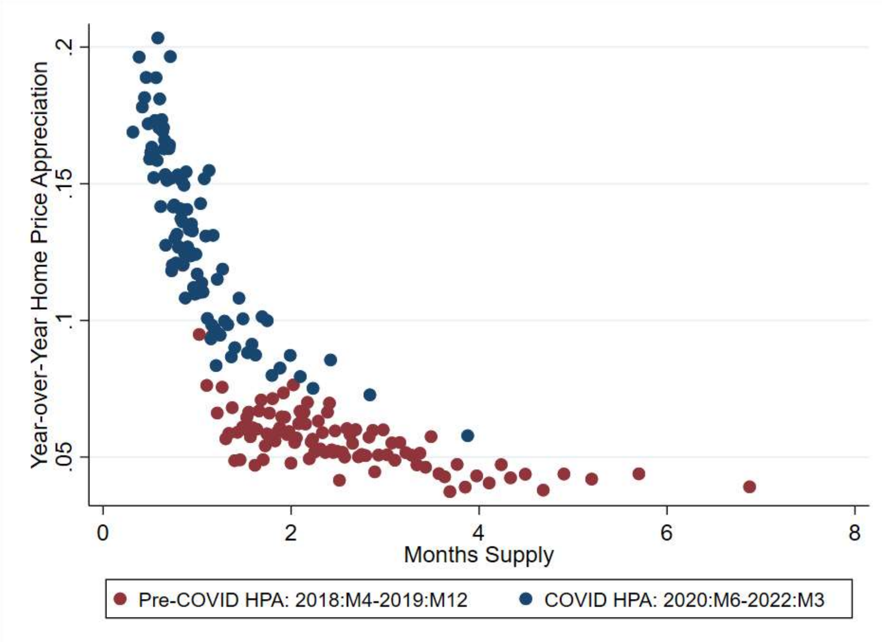
Note: Spending refers to national household credit card and debit card total spending.
* We assign each ZIP code to a quintile based on its ratio of income to area median income (AMI). The lowest quintile had a median income of 63% of AMI, while the highest quintile had a median of 136% of AMI.
Source: Commerce Signals, a TransUnion business, and AEI Housing Center.

The Fed kept expansionary monetary policies in place for too long, which helped fuel both rampant consumer price inflation and home price appreciation (HPA).

Unprecedented monetary easing with existing inventory for sale already at multi-year lows was bound to have an outsized effect on HPA as available homes for sale continued to plummet, with inventory dropping from 3.2 months of sales in February 2020 to 2.0 months by February 2021.

Research presented by Sam Khater in October 2017 at the AEI Housing Conference found that at the metro level: “Price pressures rapidly increase as supply drops below 3 months.” Just before the Fed started its pandemic credit easing, the national existing supply for February 2020 was already close to the 3-month inflection point. Within a year it would drop to 2 months and eventually drop to as low as 1.8 months. Credit easing during the pandemic, in concert with the already-low inventory, had the predictable effect of causing home prices to boom at a rapidly accelerating rate. Khater’s research would indicate that the historical relationship between months’ supply and home prices would be amplified due the severely tightened supply that occurred during the pandemic. The moderate non-linear relationship between months’ supply and home price appreciation before the pandemic became an exponential hockey stick during the pandemic. Below we show this relationship using a binned-scatterplot that combines each metro-month’s year-over-year HPA and months’ supply before the coronavirus pandemic in red (2018:M4-2019:M12) and during the pandemic in blue (2020:M6-2022:M3). Months’ supply during the pandemic reached record-low levels, as the sellers’ market of the past 10 years deepened. Real-time tracking of the housing market provided better evidence for these unprecedented times rather than relying on prior models.

Figure: Year-over-Year Home Price Appreciation and Months' Supply by Metro-Month



Source: AEI Housing Center

New data sources and innovative ways of tracking home prices and risk started to appear during the earliest days of the pandemic. As the pandemic took hold in the spring of 2020, the AEI Housing Center realized that market trends were moving so fast that data latencies of 3 months or more for the stressed MDR and HPA tracking metrics were no longer adequate. This meant that normal monthly updates needed to be replaced by weekly ones. New Center reports using real-time data from Optimal Blue were quickly developed. These were first dubbed "flash housing market indicators" and later "NowCasts". By early April 2020, the AEI Housing Center was using Optimal Blue data to monitor HPA and MDR on a weekly basis and project future HPA and MDR with a high degree of accuracy, but without the usual 3 month lag. By July 2020, recent purchase contracts indicated that HPA had accelerated to 10% (Y-o-Y) and that the MDR was declining. This was a boom induced by low borrowing costs reflecting ZIRP and the heavy and lasting dose of QE, combined with a widespread desire for more space.

Using these broadly distributed real-time data, the Fed might have pivoted much sooner from its unprecedented levels of QE and ZIRP that contributed greatly to runaway consumer and housing inflation. Instead, in August 2020, the Fed doubled down when it "approved a major shift in how it sets interest rates by dropping its longstanding practice of pre-emptively lifting them to head off higher inflation, a move likely to leave U.S. borrowing costs very low for a long time."[72] Chair Powell stated: "We've really got to work to find every scrap of leverage in helping stabilize the economy."[73] However, foreseeable consequences followed. As noted by the Housing Center a few days later: "The payment drop due to the lower mortgage rate is more than offset by the impact of the higher home price on

[72] https://www.wsj.com/articles/feds-powell-headlines-virtual-jackson-hole-economic-conference-11598486400?mod=mhp

[73] Ibid.

principal, interest, mortgage insurance premiums, property taxes and home owners insurance, and closing costs, since all of these are related to home price and mortgage amount."[74]

This new era required increased real-time tracking of the housing market. This was clear from the data sources followed by AEI's Housing Center. Here are some examples:

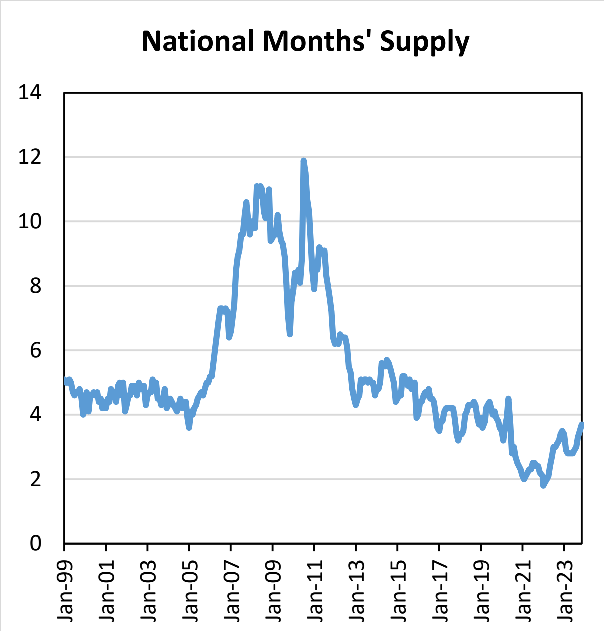
> July 2020: "Driven by ultra-low mortgage rates and a limited supply, national home price appreciation accelerated to around 10%. This rate exceeds the rate before the pandemic, which may indicate the home price boom will likely continue due to low rates and heavy demand."
>
> August 2020: "Powell's Fed has determined that inflation is now so benign that it no longer needs to raise interest rates as a precautionary action against inflationary excesses. Yet we have been feeling such excesses in capital assets, such as stocks and homes, for some time, and markets are applauding. This is perfectly foreseeable as lower interest rates get capitalized into higher asset prices."
>
> September 2020: "Low mortgage rates and continuing strong demand are adding yet more fuel to the current housing boom already 9 years in the making."
>
> October 2020: "America is running out of inventory. Buyers can't buy houses that aren't for sale, so they're bidding up the prices of the relatively few on the market. That means price increases will keep racing until more inventory comes on. And new supply will come on slowly."
>
> November 2020 : "Driven by ultra-low mortgage rates and a limited supply, national HPA is unsustainable and far exceeds the levels before the pandemic."

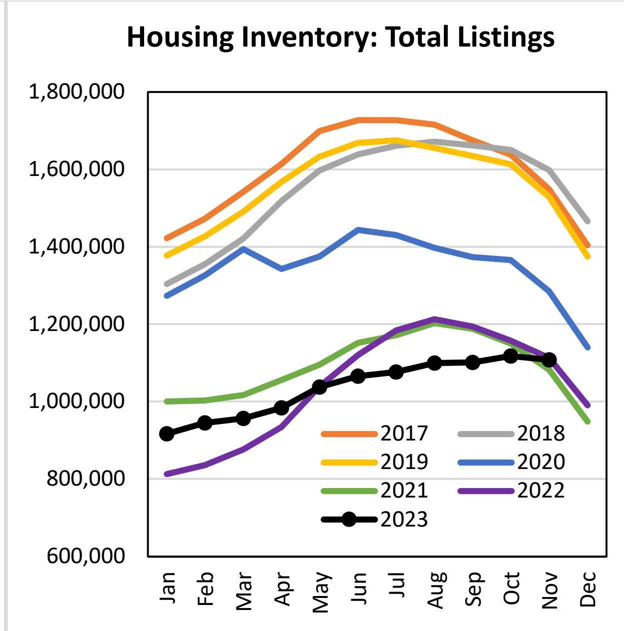
The Federal Reserve's actions to "spike the monetary punch bowl" through $5 trillion in total asset purchases, including bloating its mortgage securities investments to $2.7 trillion, and maintaining mortgage rates below 4 percent until March 2022 were in conflict with the data that from July 2020 already showed a skyrocketing housing market. Despite the evidence, the Fed did not stop MBS purchases that had buoyed its balance sheet and overheated the economy and housing market. Instead, the Fed continued to increase its assets until April 2022, despite large increases in HPA and these warning-signs of HPA and inflation to come.

Once it became clear the inflation was not transitory and in effect out of control, the Fed slammed the brakes on its expansionary monetary policies and reversed course through Quantitative Tightening (QT).

But this sharp reversal created other unintended consequences and distortions. With mortgage rates now approaching 8%, people have been unwilling to sell their homes because that would entail a higher rate mortgage. This so-called lock-in effect is one unintended consequence of the Fed's misguided policies that first kept rates too low for too long before reversing abruptly and vehemently course. With homeowners unwilling or unable to move that has removed 100,000s of units from the market for years to come. Today supply remains at lows not even seen before the Great Financial Crisis and listings remain at around two-thirds of 2017-2019 levels.

[74] https://www.aei.org/research-products/report/the-feds-spiked-punch-bowl-ad-infinitum/

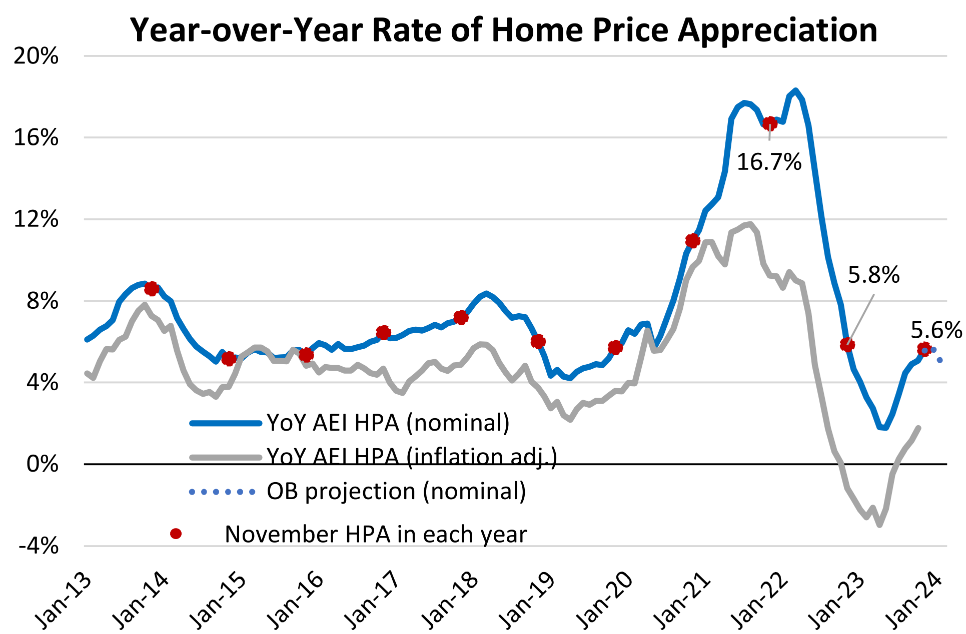




Source: NAR

Source: Realtor.com, and AEI Housing Center, www.AEI.org/housing.

What remains is an unhealthy market, where –despite an affordability shock form higher rates- home prices continue to march higher, further hurting affordability particularly for entry-level buyers.



Note: Data are for the entire country. Data for November 2023 are preliminary.
Source: AEI Housing Center, www.AEI.org/housing.