



New Approaches to Affordable Housing: Overview of the Housing Affordability Problem

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OVERVIEW OF THE HOUSING AFFORDABILITY PROBLEM

Housing has long been one of the staples of American society and the United States' economic prowess has afforded its citizens an abundance of safe and decent housing. The national homeownership rate as of Q1, 2004 is 68.6 percent, according to realtor.com. But, this success is tempered by the fact that some Americans are finding it increasingly difficult to afford housing in their communities. Housing prices are growing faster than incomes in some areas, in severe cases, pricing low-income buyers out of the market. The real estate boom of the last few years has caused housing prices to skyrocket, making it difficult for low- and middle-income families in many areas to purchase a home. Unfortunately, most of the political remedies aimed at making housing more affordable to these families don't consider the real world functioning of housing markets and wind up making the problem worse. "Affordable housing" is now in the lexicon of seemingly every state, city, and housing advocacy group. The issue has gained political momentum

in state and local government debates. This year California Gov. Arnold Schwarzenegger specifically mentioned affordable housing as an important issue he would address to enhance California's economic competitiveness, as did the governors of New Jersey, Hawaii, Oregon, and perhaps others. Local politics, particularly in high-cost areas around the nation as diverse as Madison, Wisconsin and Ft. Lauderdale, Florida, are inundated with affordable housing debates and with various candidates using the housing issue to appeal to voters and get a leg up in elections.

The National Low Income Housing Coalition released a report called "Out of Reach" identifying affordability issues. Sheila Crowley, the president of the organization, stated, "The gap between what people earn and what their housing costs are is stark." Echoing the rhetoric of most of the affordable housing community, the premise is simply that not enough low-cost housing exists. The political response to date has been largely to subsidize rental housing development, mandate "for-sale" units to be sold below market to income-restricted populations, or in some cases, to control appreciation through government intervention. However, these policy responses rely on false premises, do not

holistically attack the problem, and do not consider other solutions or unintended consequences. This policy brief explores housing affordability problems, evaluates current policies designed to increase affordability, and offers a new paradigm and new approaches for housing affordability.

Is Housing Affordable?

Housing affordability is largely a function of income. One of the best available measures for determining affordability is the Housing Opportunity Index (HOI). This index simply states the percentage of homes sold in a given area that would have been affordable to a household with the area's median income. Affordability is defined as a house payment no greater than 28 percent of gross household income. Housing advocates have further defined affordability to include rental affordability (rent payment not exceeding 30 percent of household income). The nationwide HOI as of Q4, 2004 is 52.0 (the most recent data) implying that households earning the national median income can afford nearly one-half of all houses sold. HOIs in the 1990's have been hovering in the 50s and mostly 60s implying that there has been no dramatic shift in the last decade although the index has exhibited significant decline recently. However, aggregate HOI data do not tell the whole story. HOIs in selected markets are extremely low, particularly the West Coast and parts of the Northeast. Many of the California markets are below 30, for example. The data indicate that the perception of widespread housing unaffordability is largely exaggerated, but that selected markets are experiencing unacceptably wide gaps in housing prices and income.

Aside from affordability data, there is also a widespread perception that specific classes of workers cannot afford housing in their respective communities. These include teachers, police and firefighters, and other civil servants. While there are no available comparative data on teacher or civil service compensation vs. housing prices, some data are available on teacher salaries. The link can then be made to median home prices. According to the National Education Association, the average teacher's salary was \$41,724 in 1999-2000. State ranges were relatively tight compared to regional home price variation, varying from \$55,693 in California to \$32,414 in South Dakota. Comparing this average to the national home price median of \$187,500, aggregate teacher and civil service incomes appear to be adequate on a nationwide basis. The key to applying these



data is recognizing that home prices have a much greater geographic variance than teacher and other civil service salaries. Consequently, people in these professions are punished in high-cost markets. Like housing affordability in general, the problem turns out to be more a regional or market-by-market situation rather than a nationwide phenomenon.

Further confounding an accurate assessment of the housing affordability situation is the fact that many homeowners have significant equity in their homes while they may have modest incomes. This situation tends to occur in high-cost areas where homeowners may have purchased their homes before recent price increases and are actually living in homes they would not be able to afford on their current income if they had to purchase them today. While no data exist to measure this phenomenon, it would follow that the greater it exists, the more overstated the housing affordability issue is.

AN ASSESSMENT OF CURRENT HOUSING POLICIES

The policy response to housing affordability issues has been mostly a federal, state, and municipal one despite evidence that the issue is one of a market-by-market or regional nature. While there are a variety of housing initiatives at all levels of government, this paper will focus on a select few that appear to be gaining momentum as possible solutions to housing unaffordability.

The Low-Income Housing Tax Credit

The Low-Income Housing Tax Credit (LIHTC) program provides federal tax credits to developers/investors who

construct rental housing that has a low-income component. This means that the apartment complex is market-rate, but developers/investors can receive a tax credit if a select percentage of units (usually 10 - 20 percent) are reserved for low- or moderate-income households (definition of low to moderate income has a range from 30-120 percent of the area's median income). The rent of that unit is then fixed according to the household income based on household size, essentially ensuring that the household pays no more than 30 percent of its gross income on rent.

The LIHTC program has spawned an entire industry of sorts. With state credits now available in some cases, private developers and non-profit housing associations actively seek low-income housing development opportunities. Tax credits are frequently sold or syndicated by third parties to raise equity in projects. The demand for tax credits is so great that it has become quite competitive with many developers vying for a limited number of tax credits.

While this supply-side solution has resulted in the development of several "affordable" units housing a number of low- to moderate-income residents, the program does not necessarily distribute benefits according to need. By definition, a great many people with low-moderate incomes could qualify for the affordable units, but they either have no knowledge of the program or no supply suiting their needs. Some households with the greatest needs may be on a waiting list. Furthermore, it is clear that apartments would have been constructed without the LIHTC as (1) most of the units are market-rate and (2) developers look to vacancy and local economic trends to determine if there is sufficient market support for their projects. The LIHTC simply provides tax credits to investors to rent to the same population that would have been rented to prior to the LIHTC.

In fact, the entire concept of subsidizing rental housing construction is questionable because the lack of supply is not the problem. Apartment vacancy rates are currently quite high in many markets (nationally about 7 percent), indicating that there is actually an oversupply of multi-family rental housing in some markets, but stable overall. Supply will always follow (if legally allowed) if demand is present. Therefore, it follows that a better use of public resources would be to focus on the individual or household need, not the supply of rental housing.

Inclusionary Zoning

Inclusionary zoning is a relatively new term used to

describe a concept now being advocated in California and increasingly in other areas of the country. It calls for a state or municipality to ensure that a percentage (likely 10-20 percent) of all rental and "for-sale" units constructed are "affordable." Presumably, the implementation mechanism for rental housing would be the LIHTC or some variation of it while the implementation mechanism for the "for-sale" housing would be a mandate to sell a percentage of homes in a project at below-market rates. The rental housing aspect of this policy simply amplifies all of the shortcomings of the LIHTC described earlier. The effect on the "for-sale" component of the housing market is similar and discussed below.

The HOIs in the high-cost markets signal that home prices should be the primary concern. For example, in the San Francisco Bay area, the average rent for a two-bedroom apartment is currently \$1,565 per month (excludes lower rents in Oakland and the South Bay) while the median home price is \$656,700, resulting in a \$3,356 monthly payment (assumes 10 percent down, 5.5 percent 30-year fixed-rate loan, APR). Using the household median income of \$86,100 and the 28 percent rule, it is evident that the median earner can afford the median rent, however he cannot afford the median-priced house.

Although the for-sale component of inclusionary zoning attacks the correct problem, it does so crudely and with numerous drawbacks. The primary problem with mandating that a portion of new housing be affordable to lower-income populations is determining where the burden will fall. Clearly, homebuilders are under great pressure to achieve a certain rate of return. If the projected loss on the "affordable" units does not allow that required rate of return to be met, the project will be abandoned. Addi-



tionally, the primary method available to compensate the developer for this loss is to sell the market-rate homes for a higher price to at least offset the loss on the subsidized or “affordable” units. In doing so, the cost of this policy is borne by the buyers of new market-rate housing. In effect, the problem of one person’s affordable housing issue is being transferred to many others, essentially worsening the problem.

In some instances, “density bonuses,” or rewards given for constructing housing with a higher density, are granted to developers to make up for lost revenue, but there are problems with this approach to compensating developers for providing low-income housing. First, the initial allowable density was likely artificially restricted through zoning and the land purchase price may have a density bonus factored into the price. In this way, density bonuses try to solve a problem created by regulation with more or “counter”-regulation. Second, the developer may believe that the project is not suited to higher density and therefore, chooses not to “capitalize” on the additional allowable density.

Given this example, it seems as if the policy response of rental subsidies does not attend to the real problem of out-of-reach for-sale housing in select cities. Inclusionary housing for rental housing only worsens the existing disconnect between problem and solution. In addition, there are several unintended consequences of the rental and “for-sale” strategy. One obvious example is that renters and homeowners barely qualifying for these subsidies are penalized. So, for some renters and homeowners, a small potential pay raise will result in the loss of the subsidy and a higher housing payment. This creates the peculiar situation of potentially being worse off after a pay raise. Another unintended consequence is the disruption of the housing ladder, a natural economic process. Typically, people rent when they are young. As incomes rise and family situations change, people tend to move up the housing ladder. Maybe they first seek a better apartment, then a starter home, then a bigger home, etc. Along the way, they make trade-offs regarding a number of factors—location, home size, community amenities, school districts, pricing, discretionary spending, etc. Subsidizing rents or houses in all communities breaks the housing ladder because it allows households to avoid these tradeoffs. For example, a lower-income family may find that it can live in a less expensive city within the same metropolitan area, share a car or own



an older one, rent or buy a smaller residence, or lower discretionary spending. Subsidizing this household in a more upscale community essentially limits the family’s housing choices because if and when they increase their income, they will have no option to increase their living standard. This is because the subsidy loss may likely be greater than the income gain. Thus, the only option may be to move down the housing ladder. It would seem that public policy should have the intent of doing precisely the opposite. Even worse, the subsidy can act as an enticement to earn less income or restrict one’s income growth. The potential effects on economic growth could be devastating, not to mention the lack of personal incentives to increase one’s income.

NEW PARADIGM FOR HOUSING AFFORDABILITY

Housing policy is in dire need of a paradigm shift. Society has allowed homeless activists and other housing advocates to frame and define the policy agenda for hous-

Empirical Research on Affordable Housing Mandates



Three Reason Foundation studies of affordable housing mandates (aka “inclusionary zoning,” or “inclusionary housing”) were conducted by Benjamin Powell and Edward Stringham of San Jose State University. In the San Francisco area study titled *Housing Supply and Affordability: Do Affordable Housing Mandates Work?* they found that few affordable units actually get built, totaling about 4 percent of the amount needed in the San Francisco Bay Area. The costs of the program are high, about \$45 million per jurisdiction. In addition, the costs of the program are borne, to some degree, by other homebuyers in the range of \$22,000 to \$44,000 per unit in a typical Bay Area city. (<http://www.rppi.org/ps318.pdf>).

The second study titled *Do Affordable Housing Mandates Work? Evidence from Los Angeles County and Orange County* focused on Los Angeles and Orange Counties in Southern California. Results indicated that the 13 Los Angeles and Orange County cities using inclusionary zoning produced only 6,379 affordable units and that after passing an ordinance, the typical city produces less than eight affordable units per year. The cost of inclusionary zoning in the average jurisdiction is nearly \$300 million annually. In addition, inclusionary zoning increased the cost of market-rate homes in a typical city by \$33,000-\$66,000 per unit. (<http://www.rppi.org/ps320.pdf>)



The third study, *Affordable Housing in Monterey County* analyzed the affordable housing element of the Monterey County General Plan Update. The authors identified the affordable housing contradictions in the original Monterey County General Plan Update such as restricting the supply of residential land and imposing price controls on new development and how that will likely make housing less affordable in the county. (<http://www.rppi.org/ps323.pdf>).

ing. Consequently, “affordable” has become the buzzword of choice as a euphemism for “subsidized.” Furthermore, the debate has centered on the housing unit as a measure of affordability, when in fact the hard construction cost of a housing unit is not necessarily an indication of its value. The popular approach to addressing the housing affordability issue is increasingly inclusionary zoning. This term, itself, is a euphemism, crafted carefully to appear as an anecdote to the problematic exclusionary zoning. However, inclusionary zoning is simply a mandate to sell a fraction of housing units to select groups at below-market cost while exclusionary zoning relates to a much broader set of measures used by select municipalities to limit density, minorities, or unwanted land uses or businesses.

These new housing initiatives come on the heels of the LIHTC, various HUD programs, and Community Land Trust policies, all of which have had little effect on what is widely considered the “housing crisis.” This paper has identified some of the shortcomings of these and similar approaches and will offer more economically viable approaches that attack the problem at its core.

It is unclear whether housing policy should encourage homeownership or renting. While in a perfect world housing policy would be agnostic toward the housing type and ownership form, such perfections do not exist. The LIHTC essentially encourages renting while other parts of the federal tax code favor ownership, namely the mortgage interest deduction (MID). It should be noted, however, that Richard Green, a noted land economist, demonstrated that the MID is not significant enough to entice someone into a home purchase, but rather encourage them to make a bigger purchase than they might have without it. There are other arguments of a social nature that can be made in defense of encouraging homeownership, however, that is not the focus of this paper.

Given the shortcomings of current housing policy and the overall perspective of the housing issue, a new approach to housing policy is needed. Several policy options are outlined below that address the concerns of both low-income renters and low-moderate renters and homebuyers.

Policy Option #1: Modify explicit and implicit land use and growth controls to allow homebuilders and developers the opportunity to meet demand quicker.

According to Edward Glaeser and Joseph Gyourko, Harvard and Wharton School professors who studied the sources of rising housing costs, land use controls are a significant contributor to high house prices. These land use controls include urban growth boundaries, growth moratoria, tangled and lengthy entitlement processes, and excessively high impact fees. There are also unstated controls that often limit housing. This list includes planning and architectural review and preferences for certain kinds of housing. In addition, it includes NIMBY (Not In My Back Yard) resistance to projects that may meet land use codes but are rejected due to community opposition. Loosening growth controls like boundaries or moratoria and streamlining the entitlement process would certainly result in increased “for sale” housing construction. The additional supply would almost certainly relieve pricing pressures evident in “high barrier to entry” markets.

Policy Option #2: Increase civil service compensation in select areas where incomes do not reflect high housing costs.

Areas with high housing costs have difficulty recruiting teachers and other critical workers such as police and firefighters whose compensation is not high enough to account for the high costs. Current solutions are limited to workforce housing construction and enhanced use of the LIHTC. However, given the shortcomings of such strategies previously discussed, housing policy for critical occupations needs to be retooled. The problem with larger government programs funding housing in these problematic local areas is that society at large is subsidizing a need that wealthier communities no longer have to meet. So, in effect, people with lower incomes end up subsidizing people with higher incomes because of their particular location and occupation decisions. Instead of supplying below-market housing, state and local governments should focus on increasing the compensation of these critical workers in select areas.

Policy Option #3: Encourage the use of market innovations such as location-efficient mortgages.

Not all efforts to increase housing affordability are initiated by the public sector. Fannie Mae, the nation’s largest Government Sponsored Enterprise (GSE), agreed to pilot location-efficient mortgage (LEM) products. LEMs allow borrowers to increase their gross monthly income-to-mortgage payment ratio higher than the conventional loan



standard of 28 percent (36 percent total debt). In order to qualify, the borrower must live in a location the lender deems efficient in terms of auto commuting. The premise is that by lowering a household’s automobile transportation costs, the family will have more money to allocate to their mortgage payment.

Fannie Mae sponsored a market test of the LEM, defined the guidelines of the current LEM mortgage product, agreed to invest at least \$100 million in LEMs, and authorized lenders to issue LEMs in four metropolitan market areas: Chicago, Seattle, San Francisco Bay Area, and Los Angeles. (<http://www.locationefficiency.com/>)

LEMs are not a scalable option as of yet because they are still in trial form. However, they have the opportunity to offer homeownership to a number of households that typically would not be able to afford a house. The LEM concept is somewhat conducive to the highest-cost metropolitan areas as they also tend to be the most “location-efficient” as defined by Fannie Mae. These include the aforementioned pilot markets as well as higher-cost cities like New York City, Boston, Washington, D.C., and Portland.

Policy Option #4: Assist and leverage grassroots, volunteer organizations such as Habitat for Humanity (HFH).

Local affiliates of HFH have built 50,000 safe, affordable, decent homes for United States households alone. HFH builds simple, small homes and keeps them affordable by not making a profit and offering qualified households interest-free mortgages. Although HFH receives no direct public money, local governments can assist the local affiliates by providing land and infrastructure for housing construction. In this way, costs could be kept to a minimum for qualified homebuyers. (<http://www.habitat.org/>)

Policy Option #5: Use local flexible housing vouchers to EITC (Earned Income Tax Credit) eligible households.

Traditional HUD voucher programs like Section 8 paint a broad brush with little regard for regional variations in housing affordability. In addition, the program is known to be riddled with problems including bureaucratic mismanagement and the length of time required for landlords to get paid. However, keeping the concept intact but decentralizing the administration would be beneficial. Focusing vouchers on the EITC population has the benefit of targeting the appropriate population while retaining the incentive to work, something built into the EITC in its early inception. Simply expanding the program nationwide would provide extra benefits to all recipients, but in fact this paper has highlighted the fact that housing affordability is more of a local or regional problem than a national one. Local governments, through cooperative agreements or through their Metropolitan Planning Organizations (MPOs) could offer flexible housing vouchers to EITC-qualified households. Vouchers could be offered on a sliding scale to those in need and could be used for rental or mortgage payments. The local nature of the program should greatly reduce response time and encourage participation. This also allows local areas to assess the specific nuances of their housing situation and address them more effectively.

CONCLUSION

Housing affordability and availability issues are firmly planted on the radar of local and, increasingly, state officials. With housing prices continuing to rise, there will be no shortage of highly-charged political activism and rhetoric

regarding housing for low- and moderate-income earners. But housing affordability is a regional or market-by-market problem and broad one-size-fits-all policies are ineffective, especially at the statewide level. Moreover, currently popular policies such as inclusionary zoning have too many unintended consequences and have the reverse effect of increasing housing prices.

A range of policy options can help increase the affordability of homes in a region. Policymakers should focus on these options that work within the realities of how housing markets work and the economics of homeownership. ■

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RELATED REASON STUDIES

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