AEI Housing Center

Market-oriented Reform Principles and Policies that Would Help the Housing Market

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In this election year, Congress and the President are feeling the urge to help Americans affected by rising housing affordability pressures across the country. With the status-quo untenable, Congress and the President are itching to address housing affordability, availability, and other community needs.

Before springing into action, our leaders need to first establish clear reform principles around which to design policies. The following offers such a set of market-oriented principles and policies that contrast sharply with President Biden's analysis and plan.

Reform Principles

- **Any action needs to create more supply with the aim of creating a lasting, rather than a temporary, solution.**
    - The broad consensus among academics and think tanks is that the lack of supply, which is estimated in the millions of homes, is the root cause for housing unaffordability.
- **Any action needs to free rather than hinder the market.**
    - The housing deficit is also too big to be meaningfully reduced exclusively through increased government spending.
- **Any action needs to focus on programs with a proven track record or a reasonable prospect of success.**
    - Past and future programs need to be rigorously and independently evaluated on a cost-benefit basis before being implemented, continued, or expanded.
- **Any action, while this housing shortage persists, must not create more housing demand.**
    - Demand boosters are counterproductive, as the additional demand is capitalized into higher home prices, thus further worsening affordability pressures.
- **Any action should create a safer and more stable housing finance system that promotes the interest of all Americans.**

[1] The views expressed are those of the authors alone and do not necessarily represent those of the American Enterprise Institute.

Supply-side policies

Examples of helpful ideas that advance these reform principles.

1. **Lower the costs to build a home.**

Why is this policy needed?
The National Association of Homebuilders estimates that regulations imposed by all levels of government account for 24% of the current average sales price of a new single-family home and for 41% of multifamily development costs. Regulations on workers safety, wages, appliances, chassis, or logging either add significant costs to home building or cost taxpayers and homebuyers dearly.

How can this policy be implemented?
The federal government should review and reduce its contributions to higher costs by removing unnecessary regulatory burdens.

What are the benefits?
Removing regulatory burdens does not cost any money or add to the deficit. As cost savings accrue to developers and builders, more home construction will be viable, leading to more supply. Crucially, these homes will be sold at lower price points.

What is specific legislation for Congress or the President to consider?:

a. Eliminate Davis-Bacon prevailing wage requirements on residential construction.[2]
b. Eliminate other burdensome regulations such as some Occupational Safety and Health Administration (OSHA) requirements.
c. Lower or eliminate tariffs on construction materials that add thousands of dollars to the cost of construction, which home builders pass on to consumers.[3]
d. Eliminate the chassis requirement for manufactured homes as stipulated in the ROAD Act.
e. Open more areas in national forests for logging, rather than restricting it. This would lower rather than further inflate lumber costs – a key home construction input.
f. Reduce onerous federal energy standards on appliances and building codes and refrain from implementing more onerous energy standards by the Department of Energy and by HUD or USDA that needlessly drive up the cost of housing.[4]

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[2] The Associated Builders and Contractors summarized the impact of prevailing wages as follows: "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." 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."

[3] The NAHB's single-family report states that particular standards attempt to regulate certain risks that don't exist in residential construction (e.g. beryllium), impos[e] costs significantly greater than needed to ensure worker safety (e.g. silica) or accomplishing little beyond driving up recordkeeping costs (e.g. Volks rule). According to the NAHB, OHSA standards add about 2.7% to the cost of multifamily and over 1% to the cost of single-family homes.

[4] 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.

2. **Auction off federal land for market-rate housing development.**

Why is this policy needed?
Land, particularly in many high-demand areas, is artificially scarce, which limits the market's ability to build more housing.

How can this policy be implemented?
The federal government owns vast amounts of land, particularly in the Western part of the country, where the housing shortage is worst. The federal government should auction some of this land off to the highest bidder. Sen. Harry Reid set a precedent by freeing up federal land for the Las Vegas metro.

What are the benefits?
According to estimates, this may add up to 2.4 million housing units, which would significantly lower the current shortfall. This is a proven solution that would cost no money. In fact, it would raise funds that could be used to reduce the deficit or fund housing vouchers.

What is specific legislation for Congress or the President to consider?:

a. The HOUSES Act identifies areas of federal land and it could be implemented expeditiously.

3. **Eliminate the mortgage interest tax deduction on second homes.**

Why is this policy needed?
Subsidizing second homes does not increase the homeownership rate, as second homeowners already own a primary residence. In fact, it detracts from homeownership by promoting increased competition for a limited number of homes.

How can this policy be implemented?

a. Eliminate the mortgage interest tax deduction on new second home purchases.
b. Phase out the mortgage interest tax deduction on prior second homes over 5-10 years.

What are the benefits?
This may free up to 750,000 housing units over 10 years for owner-occupancy. While this approach has not been tested, it has little downside and does not cost any money.

4. **Require HUD to release data that would allow researchers to evaluate all subsidized housing programs, including public housing, section 8, section 236, and LIHTC.**

Why is this policy needed?
These data would allow for a rigorous cost-benefit analysis of these programs. Since many parcels are on their fourth or fifth round of subsidies, HUD should be required to document, on a parcel-by-parcel basis, the extent and amount of development, renovation, and operating subsidies allocated or used over time.

How can this policy be implemented?
The data would need to include the physical condition of the property, a plan to fund the replacement and renovation of basic core components of the property, and if any fraud or abuse was ever associated with the property.

What are the benefits?
This policy does not cost any funds, but it would allow the federal government to scale the programs that have a proven track record and reduce the ones that don't.

Examples of harmful ideas that do not advance these reform principles.

1. **Expand the Low-Income Housing Tax Credit (LIHTC) and establish the Middle-Income Housing Tax Credit (MIHTC).**

Why will this policy not work?
The LIHTC program suffers from the four "Cs": cost, complexity, corruption, and crowding-out. It concentrates poverty and does not hold up to rigorous cost-benefit analysis. Portable housing vouchers are a better alternative until more housing supply has been created.

2. **Establish a one-year tax credit of up to $10,000 to middle-class families who sell their starter home.**

Why will this policy not work?
The impact would be marginal at best as the people selling these homes will want to buy or at least occupy homes elsewhere. Thus, the net effect on housing supply will be close to zero. Ultimately, the country needs to build more housing, rather than waste precious resources by shuffling occupants around.

3. **Implement the Neighborhood Homes Tax Credit to rehabilitate homes.**

Why will this policy not work?
The history of subsidized rehabilitation programs is rife with cost overruns, failed efforts, and corruption. No such program has ever successfully been scaled.

4. **Establish grants for localities that reform their zoning and land use policies or task HUD to study reform options.**

Why will this policy not work?
While this addresses in theory the root cause of the problem, it is a slippery slope. When grants fail, mandates follow. Zoning and land use policies are fundamentally state and local issues and addressing them at these levels will be superior to a one-size-fits-all federal solution. HUD has a poor track record of impartially studying reforms and its recommendation will tilt towards expensive and impractical options that have failed in the past like income-based occupancy requirements.[5]

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[5] In its recent assessment, 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

Demand-side policies:

An example of a helpful idea that advances these reform principles.

1. **Promote sustainable homeownership and wealth building for a narrowly targeted group of homebuyers.**

Why is this policy needed?
Many lower-income homebuyers have struggled to build equity.

How can this policy be implemented?
An innovative new loan product (LIFT Home) offers the answer. By combining the shorter loan term of a 20-year mortgage with a reduced mortgage rate, this program fixes the mortgage payment at the rate of a traditional 30-year fixed-rate mortgage. It thus does not enhance buying power, which makes it ideally suited for today's seller's market. The funds required to buy down the rate should be repurposed from other programs.

What are the benefits?
It does not enhance demand and offers protection from default for the borrower, which creates a more stable housing finance system.

What is specific legislation for Congress or the President to consider?:

a. The Low-Income First-time (LIFT) Home loan has already been introduced and it could be implemented expeditiously.

Examples of harmful ideas that do not advance these principles.

1. **Implement mortgage relief programs (such as downpayment assistance, interest rate assistance, or lower mortgage insurance premia).**

Why will this policy not work?
These programs boost demand against a limited supply. This will not expand homeownership opportunities but drive up home prices even more. Once these demand boosters are withdrawn, prices are susceptible to larger price declines. This creates market instability.

2. **Institutionalize mortgage forbearance programs (such as FHA's Partial Claims program or the GSE's forbearance programs).**

Why will this policy not work?
These policies have not been rigorously tested during a severe stress event. The COVID pandemic was only a limited stress event for two reasons: first, rapidly rising home prices provided borrowers with the incentive to hang on to their property, and second, the government provided massive fiscal stimulus that boosted incomes, particularly for unemployed workers. Furthermore, these policies are being used

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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.

to expand the credit box in the form of looser underwriting. Past attempts to widen the credit box have not been successful and will likely only drive-up home prices due to a lack of housing supply. Any program like these is fraught with fraud, adverse selection, and abuse.

Longer-term structural policies:

Examples of helpful ideas that advance these reform principles but will take a longer time to implement.

1. **Reduce run-away deficit spending.**

This would shrink annual deficits, which will lead to lower Treasury rates, which will in turn lower mortgage interest rates, as they are highly correlated with 10-year Treasury rates. Lower rates would also help builders and developers by lowering their cost of capital, which would allow them to undertake more projects.

2. **Shrink Fannie Mae and Freddie Mac.**

This will gradually crowd in private capital. The private system, when it develops, will be largely a prime mortgage system, under which borrowers will bear the costs of risky mortgages. It will place the housing market on a safer footing by constraining home price growth that is placing homeownership out of reach for many. For borrowers, little will change. For more details and a step-by-step description of this plan, see The Taxpayer Protection Housing Finance Plan. The shrinkage of Fannie and Freddie's outstanding government-guaranteed mortgage debt will also lead to lower Treasury rates by reducing their competition with Treasury debt.

3. **Require the Federal Housing Finance Administration (FHFA) to release data or to study appraiser bias with input from outside groups.**

While opinions about the incidence and severity of appraiser bias vary, such a study could weed out and punish bad actors and restore confidence in the home buying process for all Americans. This approach is feasible as demonstrated in our report.

Misconceptions about Housing Reform

There is a growing consensus that the solution to making housing more affordable lies in adding more housing supply, not in easy credit and market distorting subsidies. We have summarized this notion in a series 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.

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.[6]
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 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.

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[6] 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.

Misconception 4: 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.

Misconception 5: 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.