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Before the House Financial Services Committee

"Boom and Bust: The Need for Bold Investments in Fair and Affordable Housing to Combat Inflation"

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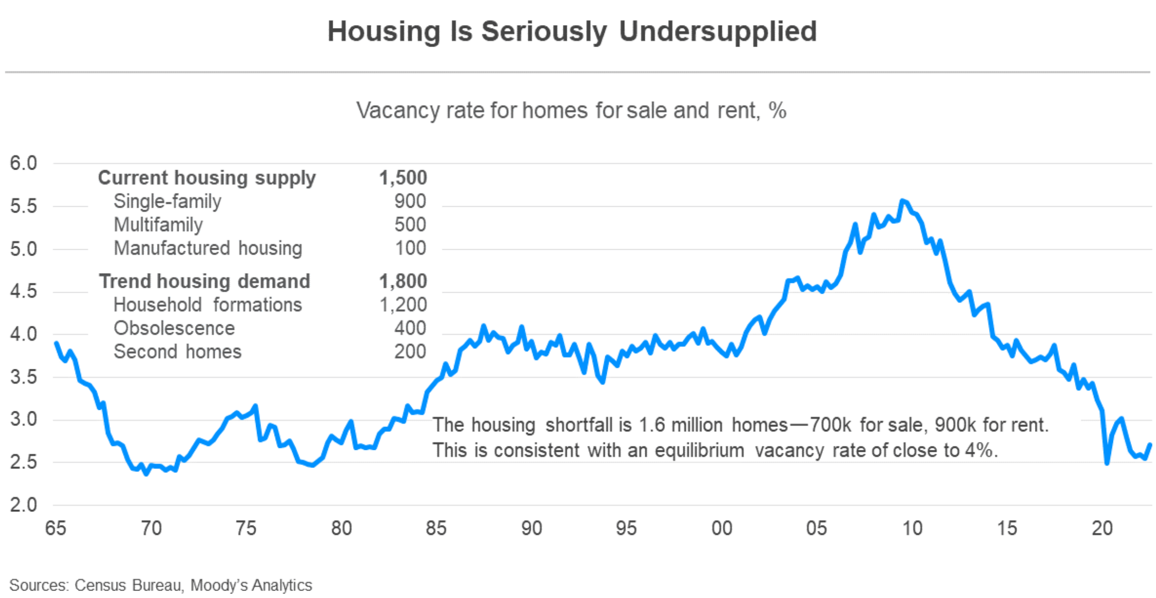
American households are struggling with the hit to their purchasing power from painfully high inflation. Prices are increasingly strongly for most goods and services—from gasoline and food to new vehicles and housing. Driving the high inflation are a number of factors including the economic fallout from the Russian invasion of Ukraine, ongoing disruptions to global supply chains and labor markets due to the COVID-19 pandemic, and a severe shortage of affordable housing. The housing shortfall has been in the making since the global financial crisis more than a decade ago and has been exacerbated by the pandemic. It is behind the extraordinarily high house prices and rents and is a key contributor to the rapid growth in the cost of housing services and overall inflation. Lawmakers should consider adopting policies to alleviate the housing shortfall and thus improve affordability to help rein in the high inflation.

The extent of the housing shortfall

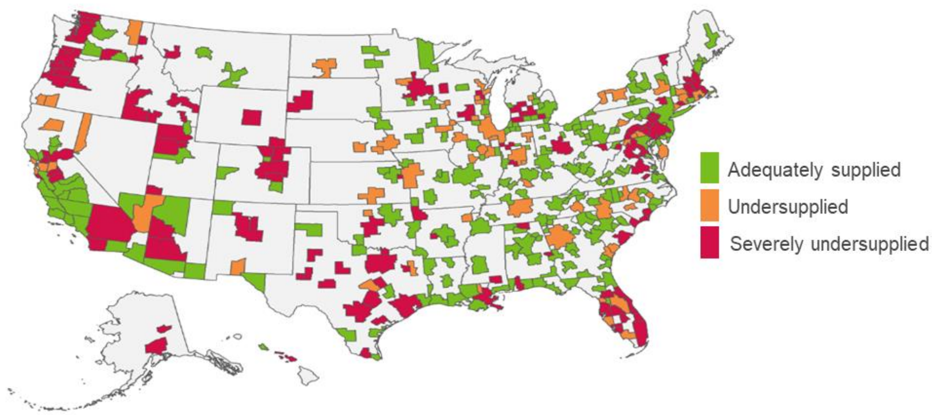
The scale of the shortfall in housing is extraordinary. There is less vacant housing available for rent and sale than at any time in 40 years, and the shortfall is set to get worse since underlying demand for new homes – the sum of household formations, obsolescence of the housing stock, and second and vacation homes – is outpacing housing supply – the sum of single and multifamily completions and manufactured housing. The current shortfall in homes is estimated at near 1.6 million units, equal to more than one year of new construction at its current pace.



Housing is in short supply in most communities across the country, and it is especially acute in Texas, Florida, parts of the Northeast Corridor, big metropolitan areas in the Midwest, much of the Mountain West, and the big metro areas on the nation's West Coast. No significant part of the country can be characterized as oversupplied.

Housing Supply Shortages Throughout Much of the Country

Based on the difference between the actual and equilibrium vacancy rate for homes for sale and rent, %

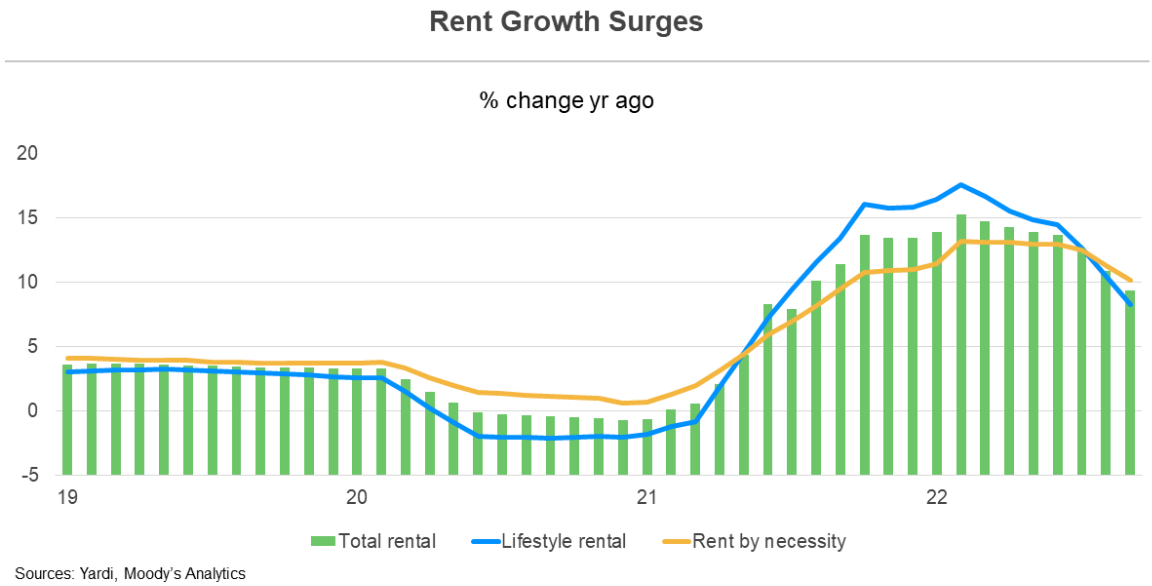


Sources: Census Bureau, Moody's Analytics

The shortfall has sent the cost of housing through the roof. Over the past decade, average annual growth in house prices has been close to 8% while the average for rents has been 5%, yet household incomes have seen yearly increases averaging only 4%. And these aggregate national numbers understate the severity of the problem. The lion's share of the undersupply is concentrated in the lower end of the market, particularly in areas that offer significant economic opportunity, driving up house prices and rents for low- and moderate-income families precisely where they want to live. Prices for homes sold in the bottom quartile of house prices are up nearly 10% per annum over the past decade, almost double that for homes in the top quartile.

The impact of the housing shortfall

This rise in the cost of housing has a wide range of negative economic consequences. Most clearly, it exacerbates the already-considerable economic divide between homeowners, who have seen their wealth rise, and renters, who are seeing their wealth erode while the possibility of homeownership drifts farther and farther away. Given the racial gap in homeownership—the homeownership rate for white households is close to 75% while it is less than 50% for Black and Hispanic households—this dynamic is in turn exacerbating the racial wealth gap.



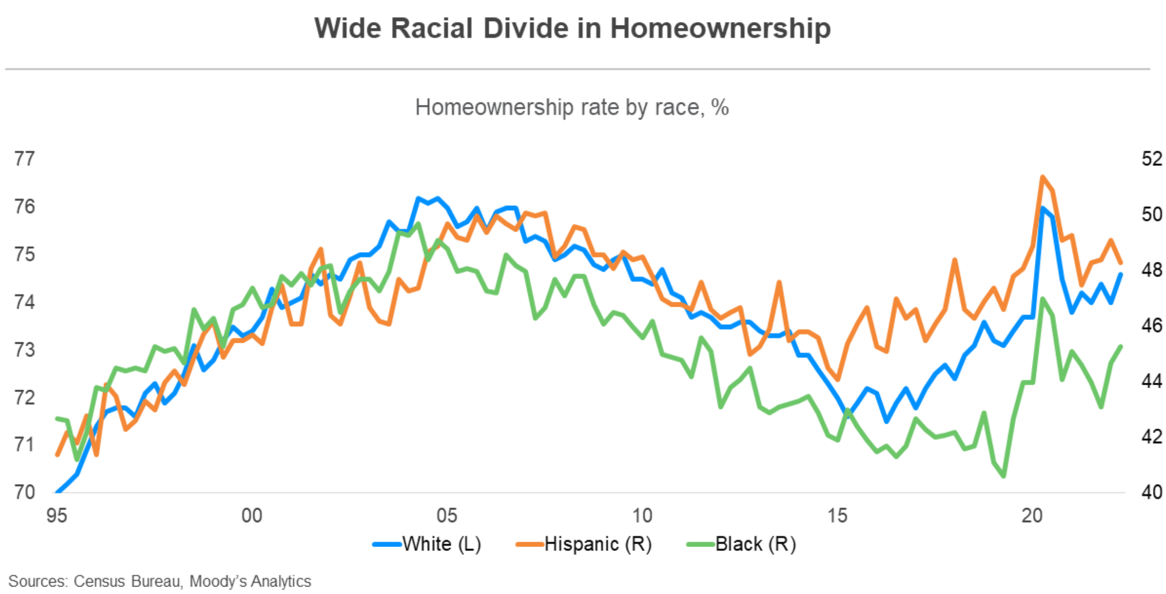
The high housing cost inflation is especially hard on renters. One in four renters pays more than half of their monthly income to the landlord, leaving barely enough to cover food, clothing and healthcare, much less save for emergencies or build wealth. The typical renter saves less than $500 a year, not enough to cover run-of-the-mill financial emergencies let alone save for a down payment on a home.

The housing shortfall is not just depressing savings and increasing the wealth gap. It is also forcing those at the bottom of the economic ladder to live farther away from those at the top and, more importantly, farther from economic opportunity. The most desirable cities are becoming affordable only to the wealthy, while many of those of more modest means are forced into longer commutes, creating more traffic, more environmental strain, and greater social division. The corollary of this is that unaffordable housing is making it harder for communities to expand economically, particularly in areas that offer significant economic opportunity. Companies are struggling to find a place where employees can afford to live. This makes it harder for firms to hire and retain workers, makes them less efficient to operate, and adds to their costs.

The severe lack of housing has also conflated with the impact of the pandemic on housing demand and supply to add significantly to the current high inflation. Housing costs alone account for one-third of the consumer price index, and the growth in housing costs added an estimated 1.2 percentage points to the year-over-year growth in the CPI through October. When the economy reopened with the introduction of COVID-19 vaccines in spring 2021 it caused already high rents to surge even higher. Demand for housing jumped as many who were living with housemates, their parents, or other family members out of financial necessity and for health reasons during the worst of the pandemic struck out on their own. The supply of housing has also been constrained by pandemic-related global supply-chain problems that limit the availability of necessary building materials and appliances and by labor shortages as the pandemic impeded foreign immigration, a critical source of workers in the construction trades. Since residential rental leases are generally for a year, it takes time for changes in rents on new leases to hit enough households and show up fully in inflation measures such as the consumer price index. But last year's big rent increases are now showing up and are adding significantly to the current high inflation.

It is encouraging that rent increases for new leases have moderated significantly in recent months, as housing demand has fallen off as the now high rents are unaffordable for many potential households and people are doubling up again. There is also more new housing supply due to the fading impact of the pandemic on supply chains and labor markets. The recent easing in the rental market should show up in slower housing cost inflation and thus overall inflation by this time next year.

But having said this, long after the impact of the pandemic on housing fades away, given the severe shortage of affordable housing, rent growth will remain persistently strong, putting consistent upward pressure on overall inflation.



What needs to be done

Issues with materials and labor, lending, and land have combined to undermine the economics of building housing at anywhere near the levels needed. These critical inputs into building a home have all been in short supply since the financial crisis, driving up their cost and reducing builders' margins and their incentive to put up more homes, particularly lower-priced housing with lower margins. To improve the situation, policymakers need to improve the economics of building, particularly at the lower end of the market.

If policymakers are serious about reining in inflation, then they have little choice but to take on the shortfall in housing supply. This means improving the economics of building enough to overcome the costs that have been holding builders back in recent years. This can be done in any number of ways, including tax breaks, grants, access to less expensive capital, and incentives to get local decision makers to ease zoning rules and restrictions on development. Grants tend to close the economic gap for local governments and philanthropies to build and renovate housing, and tax incentives tend to close the gap for private-market actors to do the same. The Build Back Better legislation passed in the House of Representatives last year included a mix of these two sources:

- $12 billion for Low-Income Housing Tax Credits (LIHTC), which provide credits to multifamily developers who commit a percentage of their units to affordable housing;
- $6 billion for the Neighborhood Homes Investment Act (NHIA), which provides tax credits to cover the cost of renovations where they exceed the resale value of a property, a problem that has kept capital out of hard-pressed urban and rural areas;
- $30 billion for HOME, the Housing Trust Fund (HTF), and the Housing Investment Fund, programs run through the Department of Housing and Urban Development that provide grants for philanthropies and local governments to build and renovate affordable housing for rent and to a lesser degree to own; and
- $10 billion for the Community Development Block Grant program (CDBG) and a new competitive grant program to reward inclusionary zoning; both programs would be run through HUD to provide communities with money to build out the infrastructure needed to create more supply.

There should be strong bipartisan support for a package along these lines. After all, the affordable housing shortage is a problem in every state and almost every congressional district. Whether lawmakers use this bill as its starting point or not, policymakers need to step up, and those worried about inflation should be first in line.

A Rare Alignment of Politics and Policy

In the next Congress, focusing on the tax-related policies will likely be more promising than grants. It is more promising economically because bringing private capital to bear to address the shortfall will be critical to addressing it at scale and over the long term, and tax incentives are typically better situated to do this than grants. And it is more promising politically because Republicans have historically been more sympathetic to expanding the incentives of private actors than increasing funding for local governments and nonprofits.

A particularly effective package of tax incentives to increase affordable housing supply could include LIHTC, the NHIA, and the New Market Tax Credit program (NMTC), the last of which would reinforce the impact of the two others with additional tax credits for equity investments in Community Development Financial Institutions (CDFI) to attract much-needed private capital to distressed communities. Each of these programs is described in more detail below.

To show the impact these tax credits could have, consider a package with funding levels that were included in BBB for LIHTC ($12 billion) and NHIA ($6 billion) and add a $7 billion increase in funding for NMTC, bringing the total 10-year static budget cost to $25 billion. This package would support the construction of an estimated 550,000 new homes over 10 years. If front-loaded over the first five years of the budget horizon, it would support more than 100,000 new homes per year through the mid-part of this decade. All told, this would reduce the existing shortfall in housing by nearly one-third over the period.

This package would have the potential for broad political support. Its impact on housing affordability should appeal to a wide range of progressives and moderates, its deflationary impact on inflation should appeal to moderates, and the tax relief should appeal to some conservatives. Each of the programs recommended already has a history of broad bipartisan support.

Increase in Housing Units Due to Proposed Housing Tax Policy

	Outlays 2023-2032	Additional housing units 2023-2032	Cost per unit 2023-2032
Provision	$ bil	Ths	$ ths
Total	25	552	45.3
Low-Income Housing Tax Credit	12	369	19.5
Neighborhood Homes Tax Credit	6	75	52.9
New Market Tax Credit	7	108	55.2

Sources: Novogradac, HUD, Moody's Analytics

Conclusion

The shortage of affordable housing for rent and sale was acute prior to the pandemic, but it has been exacerbated by the pandemic. And due to the resulting increase in house prices and rents, the shortage is adding significantly to the high inflation plaguing American households.

The Federal Reserve is aggressively raising interest rates to quell inflation. While no doubt the right course for the moment, this effort is exacerbating the rise in the cost of housing. Coming on the heels of a run up in house prices, the surge in mortgage rates resulting from the Fed’s actions has helped put homeownership out of reach for an enormous number of renters hoping to become first-time homebuyers. This has lifted demand for rental homes, thus boosting rents and inflation. Moreover, higher interest rates charged for residential housing construction lending only adds to supply headwinds, putting yet more upward pressure on rents and inflation.

Make no mistake, the housing shortage is a significant problem. It is driving up the cost of housing and homeownership and putting upward pressure on inflation that will be with us for long after the other pressures have receded. But there are solutions to this problem that make good economic and political sense.