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Let's Cut the Ammunition to the Housing Arms Race Permanently

Richard H. Serlin, *University of Arizona*

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Dean Baker in his Economists' Voice article, "Subprime Borrowers Deserve an Own to Rent Transition", proposes that homeowners facing foreclosure be given the option of remaining in their homes as renters at the market rate. I would argue that this is far from the best solution to today's epidemic of foreclosure, and more generally personal financial stress and distress. The largest roots of the problem are the great increase in economic risk over the last generation (see Hacker, 2006) and the great increase in the percentage of individual and family budgets spent on large fixed expenses, what Harvard bankruptcy expert Elizabeth Warren calls "Must-Haves" (Warren and Warren-Tyagi, 2005) .

Must-Haves are expenses that cannot be cut back on, at least not in the short run, without very serious consequences. While a family facing a layoff, illness, a suddenly doubling of their credit card interest rate, increase in their medical insurance, and/or other troubles, can immediately cut back on eating out and lattes, it cannot do the same for the mortgage, the car note, and the insurance payments, thus the name, "Must-Haves".

The typical family in 1972, even with just one earner, spent only 54% of its income on Must-Haves, but by 2005 this was up to 75%, even with both spouses working (Warren, 2007). And many families today spend over 80%, even over 90%, of their income on Must-Haves. Thus, if something goes wrong today's families have relatively little that they can cut back on to avoid an immediate disaster, or the start of a debt spiral that inevitably leads to ruin.

And it's far more likely today that something will go wrong. The economic environment has become much less secure. For example, the probability of an average American experiencing a 50% or greater drop in income over a year increased from 7% in 1970 to 17% in 2002, about 1/3 of Americans over the last two years risked illness without health insurance, and even with health insurance, the cost of illness is far higher today than a generation ago. At the same time, instead of cushioning this great rise in insecurity, government has actually been exacerbating it by following a philosophy of cutting back extensively on public risk pooling, social insurance, consumer protection regulation, and other public protections, culminating with the recent attempt to end guaranteed old age social security payments.

Why in this environment have Must-Haves increased so much? The primary reason is increased spending on housing, and Baker's solution would do little or nothing about this. The *inflation adjusted* price of the median home increased by 80% between 1970 and 2008, and this is a huge reason for today's economic insecurity. Any real solution to the housing and personal financial crises must bring down housing prices. Despite the unfortunate and misleading somber tone we see in the press about declining home prices, over the long run, this does far more good than bad.

To bring housing prices down to levels where they don't impose undue financial stress on Americans we need to consider what drove them to such unprecedented and lofty heights in the first place. Essentially it is the result of a bidding war fueled by a combination of three key factors; women entering the workforce, a prestige arms race, and a great loosening of credit regulations and standards.

The first factor developed primarily in the 1970s. As women entered the workforce, families had substantially more money to bid on homes in the desirable suburbs. This resulted in a 40% increase in real home prices between 1970 and 1979, which by and large negated any increase in the family's standard of living from the wife's working. And, it made it so that typical families needed two earners to achieve what their parents basically achieved with just one.

The second and third factors really hit between 1995 and 2005. The modern era of credit deregulation began with the 1978 Supreme Court ruling in Marquette National Bank v. First of Omaha Service Corporation (439 U.S. 299), which essentially negated all usury limits on credit card interest rates. The Depository Institutions Deregulations and Monetary Control Act followed in 1980, which pre-empted state usury laws for first lien home mortgages.

The free market began seizing on this deregulation in earnest, eventually resulting in a family's ability to borrow amounts that were unthinkable a generation ago. With the ability to charge mortgage interest rates over 20%, financial institutions were more than willing to, in return, take on the high default risks that go with saddling consumers with unprecedented levels of debt. By 2004 it had gotten to the point where the average home price to income ratio in California was over 8, as opposed to the traditional level of about 2.

The mid 90s is when debt fever really took off, with the popularization of subprime mortgage securitization. This is the packaging of a large number of sub-prime mortgages into a single standardized security and selling it to investors. Subprime mortgage securitization increased 8.5 fold between 1994 and 1998. The result was that consumers could take out far larger and riskier mortgages, and thus bring far more money to the bidding wars for homes in the safe suburbs with good schools.

The third key factor in the great rise in home prices, explained in detail in Cornell Economist Robert Frank's book *Luxury Fever*, is the prestige fever which has climbed to an unprecedented level over the last generation. Homes, and their neighborhoods, are the strongest conveyers of prestige, so certainly the prestige fever has fueled the bidding war.

Why has the prestige fever reached such unprecedented heights over the last generation? A leading explanation is that the great increase in income inequality has resulted in what Frank has termed an Expenditure Cascade.

In 1978 the top 1% received 8 times the average income; by 2006, this soared to 23 times. For the top .01% the increase was from 86 times the average income to 546 times, and the trend has been accelerating. Between 2002 and 2006, the top 1% captured almost three-quarters of income growth. Greatly exacerbating the situation, simultaneously Republican tax cuts starting in the Reagan administration and continuing through Bush II have made taxes far less progressive. The top federal income tax rate was cut by 35 points between 1979 and 2006. Average tax rates on the richest 0.01% were cut in half between 1970 and 2006, while taxes on the middle class were increased.

To illustrate the Expenditure Cascade phenomena, suppose that initially the top of 1% drove $100,000 cars, and the top 5% drove $70,000 cars. Then, income inequality increased substantially. In response to their new wealth, the top-one-percenters start driving around in $200,000 Bentleys, super-high end Mercedes and Porsches, and entry level Ferraris. This then makes the top-five-percenters feel a lot less special than they had grown accustomed to; they feel a lot poorer and lower prestige. Their $70,000 loaded Mercedes 300Es start seeming like part of a lower group, kind of every day, so they really want to move up so that their cars aren't that much poorer than the Bentleys and Mercedes 600s's they're now starting to see all over the mall parking lot. So they start buying $130,000 Mercedes 500s's and new super Lexi to keep up.

But then the top-ten-percenters see them driving these cars, and they start buying more expensive ones to try to keep up, and not lose *their* relative position. And it just keeps going, cascading right on down the line, until everyone is buying more expensive cars, all pulled in a chain by the great increases in wealth we have seen among the super wealthy over the last generation.

Thus, due to changes in government policy, economic structure, and social attitudes, we have had a great increase in family financial risk, and a housing bidding war that has lead to an explosion in home prices. And these two things, for the most part, account for today's epidemic of foreclosure and financial distress.

As I hope I've convinced you, one of the most important things we could do for American families, especially over the long run, is to bring home prices back down to sane and affordable levels. This would help tremendously to return Americans to the safe and solid tradition of only spending about 50% of their incomes on Must-Haves.

Only 50% (or less) of monthly family income spent on Must-Haves, as opposed to the current average of 74%, leaves room to save 20% of income each month. This gives us Harvard

Professor Elizabeth Warren's "Balanced Money Plan" – No more than 50% spent on Must-Haves. At least 20% to savings, and the rest for "Wants", discretionary spending on anything you'd like. I believe this is the best plan for families today, and teach it to over 500 students per year at the University of Arizona and, over 50,000 per year in my personal finance education company (See Professor Warren's "All Your Worth: The Ultimate Lifetime Money Plan").

With Must-Haves at no more than 50%, families are much better able to deal with today's far riskier world. For example, if a spouse loses his or her job, the family has 50% of its expenses that aren't fixed and can be immediately cut back on to weather the storm without descending into a ruinous debt spiral. In this example, with unemployment compensation, the typical family should have no problem cutting back and avoiding taking on debt until a new job is found.

As I've shown, however, unfortunately, the tradition of spending only about 50% of income on Must-Haves got blown out of the water by the three key changes that lead to the home bidding war. I therefore propose a massive draining of ammunition from this devastating war – strong limits on mortgage interest rates.

Legal mortgage interest rate limits could simply be made low enough that the median family would not be able to get a large enough mortgage to buy a home that would consume more than 25% of its income in monthly payments. With all other families limited in the same way, a family would still be able to buy a home in just as good a suburb. They would not be outbid, because competing families would face the same constraint. It would be like placing a severe arms limitation on all sides of a mutually self-destructive arms race.

So, families would end up in the same communities, but paying much lower prices. And this is just as it was a generation ago when we *did*, in fact, *have* severe legal limits on mortgage interest rates. The safety of a family's community and the quality of its schools would be the same (With regard to school quality, property taxes for schools would be lower, but progressive income taxes could rise to compensate. Total tax rates would then not decrease, but parents' mortgage payments would – a lot).

With *all* families limited – essentially by law through mortgage interest rate ceilings – to spending, say, half as much on housing, no family would lose its relative position. No family would end up in a lower ranked community, but the typical family would be far more financially secure, just as countries in an arms race would be far better off if *all* were limited to spending half as much on arms. No country would lose its relative position. All would be just as militarily secure, but they would have far more money to spend on their economic security and quality of life.

Severely limiting mortgage interest rates, then, would really get at the real root of the problem, and have an immensely more positive long run effect than minor tinkering, and delaying of the inevitable, as in an own-to-rent program.

To those who object saying the complete free market is always most efficient, please let me note that in spite of what screaming talk radio hosts and ideologues may say, it has been well proven in (*scientific, academic*) economics that there are many and severe inefficiencies that can result from a completely unfettered free market, and a government role can greatly alleviate these (see any university intermediate microeconomics text, especially under the headings market failure and externalities). Even Adam Smith realized that the Invisible Hand would not always work efficiently, and since "The Wealth of Nations" was published in 1776, the field of economics has advanced greatly, and shown very strongly that a substantial government role can greatly increase efficiency.

So for the sake of our families, let's permanently cut the ammunition to the housing arms race.

Richard H. Serlin teaches one of the largest personal finance courses in the country with over 500 students per year at the University of Arizona. He is also president and co-founder of AAA Personal Finance Education, a company which teaches personal finance to over 50,000 students per year.

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