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Cover Page Footnote

Special thanks to my research assistants: Allison Blemberg, George Curtis, Andrew Frohardt, Krista Poch, John Polk, Jay M. Sim, and Aaron Thompson.

THE GREAT AMERICAN HOUSING BUBBLE: RE-EXAMINING CAUSE AND EFFECT

*Robert Hardaway****

“Given the fundamental factors in place that should support the demand for housing, we believe the effect of the troubles in the subprime . . . market will likely be limited Importantly, we see no serious broader spillover to banks or thrift institutions from the problems in the subprime market”

Ben Bernanke, Chairman of the Federal Reserve (May 17, 2007)¹

SYNOPSIS

The current quest to identify scapegoats upon whom to cast blame for the housing bubble collapse are fundamentally misdirected inasmuch as all bubbles, like all Ponzi schemes, inevitably collapse—the only question being one of timing. Focus should instead be placed on the causes of the bubble itself, for only by doing so can sound economic policies be devised in a manner that will prevent future bubbles. Primary causes of the creation of the housing bubble are extravagant house subsidies lavished disproportionately on the top tiers of income earners; restriction of the supply of housing through local exclusionary policies; social policies encouraging lenders to grant mortgages to marginal buyers; the promulgation of byzantine and barely intelligible government regulations; and the cynical withdrawal of housing prices from the Consumer Price Index.

I. INTRODUCTION

In the aftermath of the Great American Housing Bubble Collapse of 2007–2010, a flurry of books, articles, opinion editorials, and television pundit sound bites have claimed to have found those most worthy of blame

* Professor of Law, University of Denver Sturm College of Law. This piece includes materials and coverage for the author’s forthcoming book, *Perfect Storm: the Great American Housing Bubble Collapse of 2007-2009: How Byzantine Regulation, Tax Subsidies, and Good Intentions Laid the Foundation for the Worst Economic Crisis Since the Great Depression* (2009).

** Special thanks to my research assistants: Allison Blemberg, George Curtis, Andrew Frohardt, Krista Poch, John Polk, Jay M. Sim, and Aaron Thompson.

¹ GILLIAN TETT, *FOOL’S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE* 181 (2009).

for the collapse.² Purported causes have ranged from a lack of regulation³ to too much regulation;⁴ from political pressure on banks to extend mortgages to unqualified buyers;⁵ to the greed of extravagantly compensated and arrogant Wall Street financiers who created exotic financial instruments designed to avoid capital requirements and attain extreme leverage;⁶ from conflicts of interest on the part of appraisers,⁷ auditors,⁸ and rating

² See generally RICHARD BOOKSTABER, *A DEMON OF OUR OWN DESIGN* (2007); WILLIAM D. COHAN, *HOUSE OF CARDS: A TAIL OF HUBRIS AND WRETCHED EXCESS ON WALL STREET* (2009); NIALL FERGUSON, *THE ASCENT OF MONEY: A FINANCIAL HISTORY OF THE WORLD* (2008); PAUL KRUGMAN, *THE RETURN OF DEPRESSION ECONOMICS AND THE CRISIS OF 2008* (2009); RICHARD A. POSNER, *A FAILURE OF CAPITALISM: THE CRISIS OF 2008 AND THE DESCENT INTO DEPRESSION* (2009); GEORGE SOROS, *THE NEW PARADIGM FOR FINANCIAL MARKETS: THE CREDIT CRISIS OF 2008 AND WHAT IT MEANS* (2008); TETT, *supra* note 2, at 181; MARK ZANDI, *FINANCIAL SHOCK: A 360° LOOK AT THE SUBPRIME MORTGAGE IMPLOSION, AND HOW TO AVOID THE NEXT FINANCIAL CRISIS* (Pearson Education, Inc. 2009) (2008).

³ VIRAL V. ACHARYA & MATTHEW RICHARDSON, *RESTORING FINANCIAL STABILITY* 32 (2009).

⁴ Roger Lowenstein, *Tax Break: Who Needs the Mortgage-Interest Deduction?*, N.Y. TIMES, Mar. 5, 2006, § 6 (Magazine), at 79; Ron Paul, *Don't Blame the Market for the Housing Bubble*, Mar. 20, 2007, <http://www.lewrockwell.com/paul/paul376.html> ("Fed intervention in the economy – through the manipulation of interest rates and the creation of money – caused the artificial boom in mortgage lending."); Hans Bader, *Affordable Housing, Diversity Mandates Caused Mortgage Crisis*, Aug. 5, 2008, <http://www.openmarket.org/2008/08/05/affordable-housing-diversity-mandates-caused-mortgage-crisis/> ("As a *Washington Post* story shows, the high-risk loans that led to the mortgage crisis were the product of regulatory pressure, not a lack of regulation. In 2004, even after banking officials 'warned that subprime lenders were saddling borrowers with mortgages they could not afford, the U.S. Department of Housing and Urban Development helped fuel more of that risky lending. Eager to put more low-income and minority families into their own homes, the agency required that two government-chartered mortgage finance firms purchase far more "affordable" loans made to these borrowers. HUD stuck with an outdated policy that allowed Freddie Mac and Fannie Mae to count billions of dollars they invested in subprime loans as a public good that would foster affordable housing.' Lenders also face the risk of being sued for discrimination if they fail to make loans to people with bad credit, which often has a racially-disparate impact (proving that such impact is unintentional is costly and difficult, and not always sufficient to avoid liability under antidiscrimination laws). They also risk possible sanctions under the Community Reinvestment Act.") (emphasis removed); Thomas Sowell, *Bankrupt "Exploiters"*, July 22, 2008, http://townhall.com/columnists/ThomasSowell/2008/07/22/bankrupt_exploiters?page=2 ("It was government intervention in the financial markets, which is now supposed to save the situation, that created the problem in the first place.")

⁵ William C. Apgar & Mark Duda, *The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges*, 9 FED. RES. BANK N.Y. ECON. POL'Y REV., June 2003, at 169, 169; Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending*, N.Y. TIMES, Sept. 30, 1999, at C2; Dennis Sewell, *Clinton Democrats Are to Blame for the Credit Crunch*, THE SPECTATOR, Oct. 4, 2008, at 14, 15 ("Changes were made to the Community Reinvestment Act to establish a system by which banks were rated according to how much lending they did in low-income neighborhoods. . . . A poor rating could be disastrous for a bank's business plan. . . . At the same time, the government pressed Freddie Mac and Fannie Mae, the two giants of the secondary mortgage market, to help expand mortgage loans among low and moderate earners, and introduced new rules allowing the organisations to get involved in the securitisation of subprime loans."); Sowell, *supra* note 5 ("Laws and regulations pressured lending institutions to lend to people that they were not lending to, given the economic realities. The Community Reinvestment Act forced them to lend in places where they did not want to send their money, and where neither they nor the politicians wanted to walk.")

⁶ Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. Feb. 23, 2009 at 7, 32-44 ("The factor that levered a serious housing market bubble and collapse into a threat to the United States financial markets and, indeed, the world financial system, was the financial innovations that developed on Wall Street as a result of securitization.")

⁷ David Streitfeld & Gretchen Morgenson, *Building Flawed American Dreams*, N.Y. TIMES, Oct. 19, 2008, at A1 (stating that by allowing lenders to hire their own appraisers, which often resulted in inflated house valuations, HUD fueled the mortgage engine).

agencies,⁹ to incompetent regulators;¹⁰ and from the greed of homeowners¹¹ to the greed of lenders.¹²

In the aftermath of collapse it is tempting to find scapegoats, especially in light of studies showing that virtually all of those even remotely connected to the housing bubble collapse are most likely to blame everyone but themselves. As John F. Kennedy is purported to have said in the aftermath of the Bay of Pigs disaster in 1961, “victory has a hundred fathers and defeat is an orphan.”¹³ Nowhere was this adage more apt than in describing the manner in which politicians during the housing bubble were eager to take credit for increasing home ownership in the U.S. from 65% to 68%,¹⁴ but nary a one could be found willing to take responsibility for the subsequent collapse.

From 1940 to 2000, there was not a single ten-year period in which the average price of a house in the U.S. did not rise¹⁵ (even factoring in inflation), thus creating the greatest asset bubble in the economic history of mankind. This asset bubble covered up a plethora of sins, revealed only in the aftermath of collapse. Indeed, there is now evidence that virtually all the sins cited by the pundits were in fact committed, at least to some degree, though the perspicacity of these critics was apparently triggered only by the stripping away of the protective immunities provided by the bubble itself.

⁸ Brian E. Robison, *Litigation in the Wake of the Subprime Lending Collapse: What Has Happened and Where We Are*, in FIRST FOCUS: THE SUBPRIME CRISIS 59, 61 (Jodine Mayberry ed., Thomson West 2008).

⁹ M. Ahmed Diomande et al., *Why U.S. Financial Markets Need a Public Credit Ratings Agency* 4 (Wall Street Watch, Working Paper No. 2, 2009, available at http://www.wallstreetwatch.org/working_papers/Public_Credit_Ratings_Agency.pdf).

¹⁰ See *Bank Shot*, NEW REPUBLIC, Feb. 13, 2008, at 1; David Enrich & Damian Paletta, *Failed Lender Played Regulatory Angles --- Red Flags Flew but Lamb's Banks Kept Pouring out Loans, Till They Collapsed*, WALL ST. J., Oct. 3, 2008, at A1; Alan Greenspan, *Monetary Myopia*, ECONOMIST, Jan. 14, 2006, at 67, 69.

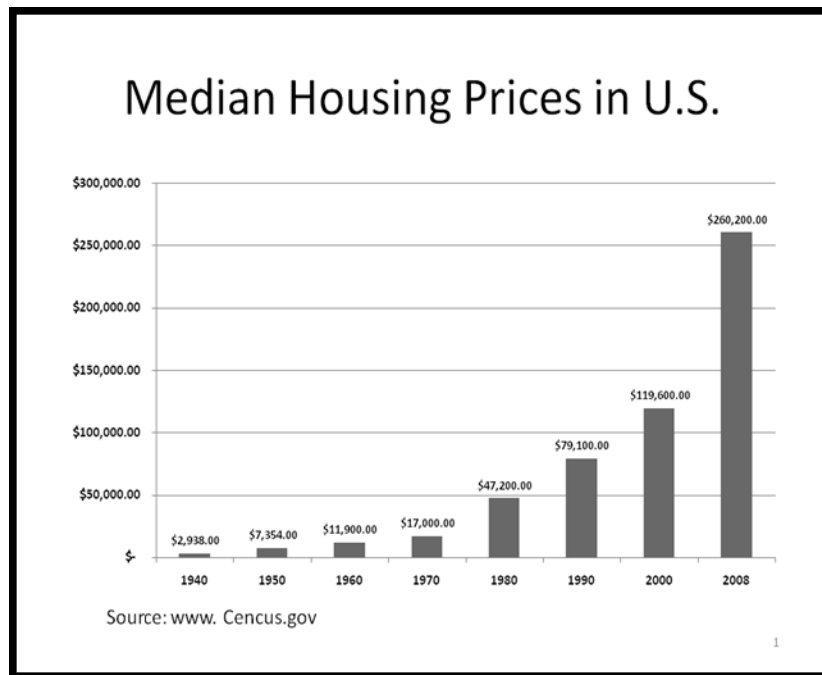
¹¹ See Chris Thornberg, *It's Unfair Prices Not Unfair Loans*, L.A. TIMES, Mar. 24, 2008, <http://www.latimes.com/news/opinion/sunday/commentary/la-op-leonard-thornberg24mar24,0,4323373>. story (“[M]any people made a very unwise decision in recent years: They bought a house they couldn’t possibly afford. . . . Now that the house of cards is falling, all parties are taking a hit. But it all started with buyers who bought something they couldn’t afford and listened to the words they wanted to hear to help themselves justify that bad decision.”); see also ZANDI, *supra* note 3, at 45-63.

¹² Steven R. Weisman, *Fed Sets Rules Meant to Stop Deceptive Lending Practices*, N.Y. TIMES, July 15, 2008, at C4 (“The Federal Reserve adopted sweeping rules on Monday aimed at barring abusive or deceptive mortgage lending practices of the kind that analysts say have led to widespread delinquencies and foreclosures, a collapse of the housing market and an economic downturn.”); see also Gregory J. Wilcox, *Greed Is to Blame for Housing, Credit Crisis*, THE DAILY NEWS OF L.A., Aug. 3, 2008, at A28.

¹³ ARTHUR M. SCHLESINGER, JR., *A THOUSAND DAYS* 289 (Houghton Mifflin 1965).

¹⁴ U.S. CENSUS BUREAU, ANNUAL STATISTICS: 2005: HOME OWNERSHIP RATES BY AREA: 1960 TO 2005, <http://www.census.gov/hhes/www/housing/hvs/annual05/ann05t12.html> (last visited Nov. 11, 2009).

¹⁵ U.S. CENSUS BUREAU, CENSUS OF HOUSING: HISTORICAL CENSUS OF HOUSING TABLES HOME VALUES (2004), <http://www.census.gov/hhes/www/housing/census/historic/values.html>.



The Community Reinvestment Act (“CRA”), seemingly benign when passed in 1977 for the purported purpose of eliminating discrimination in mortgage lending, began to look more like a prime suspect in the quest for culprits in the aftermath of the housing collapse.¹⁶ Indeed, there is now little doubt that its progeny in the form of regulations promulgated in the mid 1990s with the purpose of putting teeth into the CRA by setting quotas for mortgage lending to distressed communities and threatening sanctions for banks who did not meet them, played at least some role in the collapse, though the extent of its role remains fiercely debated.¹⁷ Likewise, the greed

¹⁶ The Community Reinvestment Act, 12 U.S.C. § 2901 (2006); see also Raymond H. Brescia, *Part of the Disease or Part of the Cure: The Financial Crisis and the Community Reinvestment Act*, 60 S.C.L. REV. 617, 619 (2009).

¹⁷ See 12 C.F.R. pts. 25, 228, 345, 563e (2009); see also *The Community Reinvestment Act: Thirty Years of Accomplishments, but Challenges Remain: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 103 (2008) (statement of Sandra F. Braunstein, Director, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_house_hearings&docid=f:41181.wais.pdf (“The CRA regulations were substantially revised again in 1995, in response to a directive to the agencies from President Clinton to review and revise the CRA regulations to make them more performance-based, and to make examinations more consistent, clarify performance standards, and reduce cost and compliance burden. This directive addressed criticisms that the regulations, and the agencies’ implementation of them through the examination process, were too process-oriented, burdensome, and not sufficiently focused on actual results.”); White House Press Briefing, Office of the Press Secretary (Dec. 8, 1993), <http://clinton6.nara.gov/1993/12/1993-12-08-briefing-by-bentsen-and-rubin.text.html> (paraphrasing, by Eugene Ludwig, then Comptroller of the Currency, that the 1995 CRA reform would entail “replacing paperwork requirements with performance tests,” to stimulate bank lending, investment and service in low and moderate income communities).

and recklessness of investment banks in attaining extreme leverage by sidestepping reserve requirements and creating exotic financial instruments, such as collateralized debt obligations (“CDOs”) and structured investment vehicles (“SIVs”), is now well documented in an avalanche of books and articles now flooding the market.¹⁸ Conflicts of interest in the appraisal, auditing, real estate, and credit rating agency spheres of the housing market, overlooked or disregarded during a period of rising housing prices, have become the focus of both scrutiny and litigation since the housing collapse.

What was not anticipated, by even as knowledgeable a financial expert as the Chairman of the Federal Reserve, was the effect that a seemingly manageable rise in foreclosures in the subprime market would have on the entire economy. Indeed, all those who failed to anticipate that catastrophic effect would have been well to watch the old film classic *It's a Wonderful Life*, directed by Frank Capra and starring Jimmy Stewart and Donna Reed. Film buffs may recall that in that film a seemingly inconsequential event—the sighting by a customer of a bank employee's misplacement of a bag containing the daily deposits—triggered a panic among the entire community that the bank would soon be insolvent.¹⁹ Within hours, every depositor in the bank arrived at the bank's doors demanding to withdraw all their money. Because 80% of the bank's assets were tied up in long-term mortgages, while the deposits were subject to withdrawal on demand, the result was the classic “run” on the bank, which if not staunches must inevitably lead to the bank's failure.²⁰

What happened in 2007–2008 followed this script almost to a tee. What seemed to the Federal Reserve Chairman at the time to be a relatively inconsequential and manageable event—the rise in foreclosures in the subprime market—led to a dramatic collapse in confidence in the soundness of other mortgages (particularly the so-called “Alt-A” mortgages). Partly this was because for the first time, investors now felt the need to go beyond the agency ratings and examine for themselves the soundness of the mortgages in which they had invested. The problem was that this was almost impossible to do, because the mortgages had been sold by their originators to investment houses or government agencies, which sliced and diced them into little pieces—a process now referred to as “securitization”—and then resold as financial securities around the world.²¹ Though these securities had been billed as safe and “diversified”—based on having divided them into “tranches” based on the creditworthiness of individual borrowers within each tranche—that diversification was

¹⁸ See, e.g., Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It*, 2009 U. ILL. L. REV. 1359 (2009).

¹⁹ *IT'S A WONDERFUL LIFE* (1946).

²⁰ *Id.*

²¹ See, e.g., Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257, 1265 (2009).

immediately questioned by investors when they realized that all their investment had been put into one basket (houses), and were no more diversified than investment in different types of tulips had been during the great Dutch Tulip Bubble of 1634.²² Faced with this uncertainty, traditional lenders in the overnight “repo” market—money market and hedge funds—precipitously began to decline to lend to investment houses such as Bear Stearns, which had previously relied on their inventory of CDOs derived from home mortgages, and instead demanded more security. In the face of such precipitate loss of funding, the great investment houses desperately tried to sell their CDOs to raise cash, only to find that there was no market at all for them in light of investor fears of their value. Under a government accounting regulation that required assets be “marked to market” (rather than on an independent evaluation of their intrinsic worth), investment banks such as Bear Stearns found their net worth reduced from a value of at least eighty dollars a share to less than two dollars in the space of forty-eight hours (a saga now well documented in William Cohan’s 2009 book, *House of Cards*).²³

With investor confidence shattered by the dramatic fall of Bear Stearns (ultimately bought by J.P. Morgan for the charitable penny-stock price of two dollars a share²⁴), the run was on—not only on banks around the world, some of whom could withstand the onslaught due to government deposit insurance coverage, but more disastrously on the “shadow banking” system worldwide, which had been constructed through the creation of SIVs by legitimate banks seeking to quarantine their debt obligation in independent entities, but that were not protected by any kind of government deposit insurance.

It was, therefore, not surprising that a litigation explosion occurred in the aftermath of the collapse triggered by losses in virtually every nook and cranny of the economy. Foreclosures have risen dramatically, rising by 75% in 2007 and exceeding 320,000 in each of the first two quarters of that year alone.²⁵ However, what in quainter times were considered to be routine, foreclosure actions have degenerated into nightmarish legal tangles in the aftermath of securitization. In such a morass, lawyers and courts alike

²² FERGUSON, *supra* note 3, at 136; Peter M. Garber, *Famous First Bubbles*, J. ECON. PERSP. 35, 37 (Spring 1990); see Mark Frankel, *When the Tulip Bubble Burst*, BUS. WK., Apr. 24, 2000, at 22.

²³ COHAN, *supra* note 3, at 126-128.

²⁴ Bill Barnhart, *Economy Moves into Uncharted Territory*, CHI. TRIB., Mar. 18, 2008, at 1.

²⁵ Howard Mulligan, *As Lawmakers Tackle the Subprime Crisis, Professional Vigilance Is a Must*, in FIRST FOCUS: THE SUBPRIME CRISIS, 77, 79 (Jodine Mayberry ed., Thomson West 2008) (“More than 320,000 foreclosures were initiated during each of the first two quarters of 2007, most of which were related to subprime loans, versus a typical level of 225,000 over the preceding six years.”); RealtyTrac, *U.S. Foreclosure Activity Increases 75 Percent in 2007 According to RealtyTrac U.S. Foreclosure Market Report*, in FIRST FOCUS: THE SUBPRIME CRISIS, 194-95 (Jodine Mayberry ed., Thomson West 2008) (a chart illustrating 2,203,295 total foreclosure filings in 2007; 75% more than in 2006); Les Christie, *Foreclosures up 75% in 2007*, Jan. 29, 2008, http://money.cnn.com/2008/01/29/real_estate/foreclosure_filings_2007/.

have found it difficult to determine the real party in interest entitled to bring the foreclosure action in a byzantine, often thin chain of creditorship extending from the borrower to the ultimate purchaser of the CDOs derived from the original mortgage.²⁶ Homeowners have fought back with counterclaims of their own, alleging that their creditors should have known better than to loan to them without requiring a down payment or verification of employment, throwing in for good measure claims of deceptive trade practices, predatory lending, and improper or confusing disclosure-of-loan terms.²⁷ Investors have sued market and hedge funds, alleging breach of fiduciary duty in mismanaging risk.²⁸ Real estate investment trusts have sued investment banks for bad advice,²⁹ and customers have sued banks for engaging in risky subprime lending without proper disclosure.³⁰ Realtors and developers are under threat of suit for recommending mortgage brokers who in turn placed a borrower with an alleged predatory subprime lender.³¹

Prior to the bubble collapse, appraisers who appraised property based on pressure from real estate agents rather than their own independent judgment had little fear of liability because rising home prices rendered moot any overly generous appraisal. Credit rating agencies, pressured to award high ratings by investment banks, likewise had little to fear from a collapse in the value of CDOs, because rising home prices assured that this collateral would remain secure; and likewise down the line, from hedge-fund managers to investment banks that engaged in high leverage. As long as the bubble continued expanding, everyone was happy and safe from both major losses and liability.

And these issues are only the tip of the civil litigation iceberg spawned by the housing collapse. On the theory that *someone* has to pay, federal and state prosecutors have initiated thousands of criminal prosecutions relating to the housing collapse. Within just the first few months after the first signs of housing collapse in 2007, the FBI alone

²⁶ Robert J. Ridge & Lauren D. Rushak, *Identifying the Categories of Disputes Emerging from the Subprime Meltdown*, in FIRST FOCUS: THE SUBPRIME CRISIS 11, 11 (Jodine Mayberry ed., Thomson West 2008); see, e.g., *In re* Foreclosure Cases, 521 F. Supp. 2d 650 (S.D. Ohio Nov. 15, 2007); *In re* Foreclosure Cases, No. 1: 07CV2282, 07CV2532, 07CV2560, 07CV2602, 07CV2631, 07CV2638, 07CV2681, 07CV2695, 07CV2920, 07CV2930, 07CV2949, 07CV2950, 07CV3000, 07CV3029, 2007 U.S. Dist. LEXIS 84011 (N.D. Ohio Oct. 31, 2007).

²⁷ Robison, *supra* note 9, at 61.

²⁸ *Id.* at 64-65 (asserting that hedge funds that had invested heavily in mortgage-backed securities that are now virtually worthless due to the high default rates are suing hedge fund managers claiming that the hedge fund managers failed to conduct adequate due diligence before investing in those securities, failed to disclose the risks of those holdings to investors in the fund, or failed to account for the risk of default on their books); *id.* at 70 (stating that investors could argue that the hedge fund did not make prudent investments, failed to follow internal guidelines, or failed to manage risk).

²⁹ *Id.* at 70 (“[R]eal estate investment trusts are suing the banks in connection with specific transactions, including repurchase or swap agreements.”).

³⁰ *Id.* at 69.

³¹ *Id.* at 61 (“Realtors and developers could be sued . . . if they recommended the mortgage broker who eventually placed a borrower with a subprime lender.”).

initiated over 1,200 mortgage-related-crime probes and established a task force of prosecutors and law enforcement officers.³²

With the “causes” of the housing bubble collapse so well documented and examined, it would be of marginal value to simply restate that documentation, or even to try to pick a primary cause. Rather, the theme of this piece is that how the bubble collapsed is less important than how the bubble was created in the first place. While the case can certainly be made that it took a “perfect storm” of confluent events to produce the collapse, such a case must inevitably come down to the more prosaic matter of simple timing. Economic history reveals that all financial bubbles, like all Ponzi schemes, have inevitably collapsed. The only question is when. Without a bubble, there can be no collapse. For that reason, the creation of the housing bubble will be the focus in the following sections and the causes examined only by way of background.

Part II will review the current debate. Part III will document the creation of the housing bubble. Part IV will set forth policy recommendations for avoiding future bubbles.

II. THE CURRENT DEBATE

The current debate over causes of the bubble collapse has polarized into two main camps. The wisdom of the first camp, led by such financial gurus as George Soros³³ and Paul Krugman,³⁴ comes down to one simplistic explanation—namely, that deregulation and insufficient regulation were the ultimate culprits in the credit crisis, fed by the greed of financial manipulators, incompetent or disinterested regulators, unscrupulous speculators, and to a lesser extent, homeowners themselves. Not surprisingly, the solutions proposed by this camp range from keeping prices high (particularly home prices), bailing out banks and failing companies, and implementing still more layers of regulation.³⁵

The majority of books and scholarly articles now flooding the market tend to fall in this camp, as do the talking heads and television pundits who opine, in effect, that it would be the greatest tragedy if home prices were to be allowed to fall to levels at which the average person could actually afford them. It is not surprising, therefore, that in the aftermath of the bubble collapse, government policy has to date largely been in accord with the solutions tendered by this group. For example, federal government policy has been largely geared toward keeping home prices high by granting

³² Paritosh Bansal, *FBI: Mortgage Fraud Cases up “Exponentially,”* Dec. 6, 2007, <http://www.reuters.com/article/businessNews/idUSN0626112820071207?pageNumber=1&virtualBrandChannel=0>.

³³ See SOROS, *supra* note 3, at 91-93.

³⁴ See KRUGMAN, *supra* note 3, at 147.

³⁵ See SOROS, *supra* note 3, at 92-93.

subsidies to homebuyers. Recent legislation has showered new homebuyers with tax subsidies of \$8,000.³⁶ Because this legislation does not require that the recipient of the subsidy owes any taxes at all, the subsidy amounts to cash grants to homebuyers directly from taxpayer coffers. The so-called “Cash for Clunkers”³⁷ program has been implemented on a similar theme, handing out cash grants to any person willing to have his perfectly good vehicle destroyed by means of a toxic dose of sodium silicate while the engine is running at 2,000 rpm to insure total destruction within seven minutes.³⁸ By such means, over 700,000 functioning vehicles have been destroyed³⁹ in order to keep the price of used cars high—all in return for buying a new vehicle (mostly foreign models and SUVs) that gets a scant few miles per gallon more than the vehicle destroyed.

In this respect, the government is harkening back to Depression-era solutions. In 1933, in the so-called Agricultural Adjustment Act, Congress attempted to keep prices high by paying farmers not to grow food, mandating the destruction of existing crops, ordering the plowing up of cotton, and killing pregnant pigs and cows—all at a time when millions of Americans were going hungry.⁴⁰

The wisdom of the second camp, on the other hand, is that adding layers of additional regulation is hardly a viable solution at a time when homebuyers are already faced with documents and government mandated disclosures in heaps of paper often stacked a foot high at closing. According to a study by the Competitive Enterprise Institute,⁴¹ in 2008 alone federal regulatory agencies issued 3,830 “‘final’ rules,” each of which consisted of hundreds, and often thousands, of pages of barely intelligible regulations. The study further found that “[t]he total regulatory compliance costs of all these regulations hit \$1.172 trillion in 2008” □ or almost as much as the entire amount the government raised in individual tax revenues for the same year.⁴² More regulations are being prepared: “‘61 federal departments, agencies, and commissions have 4,004 regulations in play at various stages of implementation . . . 180 are “economically significant”

³⁶ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 225 (2009) (to be codified at 42 U.S.C. § 17384); First-Time Home Buyer Tax Credit, <http://www.federalhousingtaxcredit.com/2009/faq.php> (last visited Oct. 1, 2009) (authorizing a tax credit of up to \$8,000 for qualified first-time home buyers purchasing a principal residence on or after January 1, 2009 and before December 1, 2009).

³⁷ CARS: Car Allowance Rebate System, <http://www.cars.gov> (last visited Oct. 30, 2009).

³⁸ Robert Hardaway, *Cash for Clunkers Program Is Like Burying a Pregnant Cow*, DENVER POST, Aug. 8, 2009, http://www.denverpost.com/guestcommentary/ci_13016354.

³⁹ Press Release, Dep’t of Transportation, DOT 150-09, *Cash for Clunkers Payout Nearly Complete 1* (Sept. 25, 2009) (available at <http://www.cars.gov/files/official-information/September25PR.pdf>).

⁴⁰ H.W. BRANDS, *TRAITOR TO HIS CLASS 329* (2008).

⁴¹ Steve Forbes, *Parallel Universe—D.C Style*, FORBES MAG., June 22, 2009, at 15.

⁴² *Id.*

rules, packing at least \$100 million in economic impact.”⁴³

In the case of the housing bubble collapse, a one page regulation setting forth a capital requirement of at least 20%-- not only for banks, but also for the “shadow banking system” created by Wall Street whiz kids who devised the SIVs for the very purpose of avoiding capital requirements— would have served far better than the hundreds of thousands of barely intelligible regulations mass produced by dozens of overlapping federal agencies.

Likewise, far more effective in preventing foreclosures than the mounds of disclosure documents written in fine print and legalese might have been a regulation requiring that a one page document be provided to homebuyers for signature at closing stating in sixteen point bold letters, something along the lines of: **“I UNDERSTAND THAT MY MONTHLY PAYMENT MAY DOUBLE IN SIX MONTHS, AND THAT MY INTEREST RATE MAY TRIPLE BY NEXT YEAR. I FURTHER UNDERSTAND THAT, STATISTICALLY, GIVEN MY LOW DOWN PAYMENT AND UNSATISFACTORY CREDIT HISTORY, MY CHANCES OF LOSING MY HOME TO FORECLOSURE WITHIN THREE YEARS EXCEEDS 90%.”**

But perhaps no issue is more contentious than the question of the role of the Community Reinvestment Act (and enforcing regulations promulgated in the mid-1990s) in the bubble collapse, with the first camp maintaining that only a relatively small percentage of lending institutions were covered by the CRA,⁴⁴ and that in any case the CRA did not require that loans be made to borrowers who were not creditworthy.⁴⁵ Those in the second camp respond that the CRA nevertheless put pressure even on banks not formally covered, and that the threat of sanctions increased that pressure. They point to an admission by the Chief Executive Officer of Countrywide Financial that in order to avoid punishments in the CRA for failure to meet quotas for lending to distressed communities, “lenders have had to stretch

⁴³ *Id.*; see CLYDE WAYNE CREWS, JR., THE TEN THOUSAND COMMANDMENTS: AN ANNUAL SNAPSHOT OF THE FEDERAL REGULATORY STATE 2 (2009), http://cei.org/cei_files.fm/active/0/Wayne%20Crews%20-%202010,000%20Commandments%202009.pdf (“According to the 2008 Unified Agenda, which lists federal regulatory actions at various stages of implementation, 61 federal departments, agencies, and commissions have 4,004 regulations in play at various stages of implementation. Of the 4,004 regulations now in the pipeline, 180 are ‘economically significant’ rules packing at least \$100 million in economic impact. Assuming these rulemakings are primarily regulatory rather than deregulatory, that number implies roughly \$18 billion yearly in future off-budget regulatory effects. ‘Economically significant’ rules increased by 13 percent between 2007 and 2008 (following a 14-percent increase the year before). As noted, high federal budgetary spending now likely implies higher future regulatory costs as well.”).

⁴⁴ Fed. Fin. Inst. Examination Council, Community Reinvestment Act, <http://www.ffiec.gov/CRA/default.htm> (last visited Oct. 1, 2009).

⁴⁵ Fed. Reserve Bd., Community Reinvestment Act, <http://www.federalreserve.gov/dcca/cra/> (last visited Oct. 1, 2009).

the rules a bit.”⁴⁶

An economist at the Brookings Institution, Robert Litan, told the *Washington Post* earlier this year that banks “had to show they were making a conscious effort to make loans to subprime borrowers.”⁴⁷ The much criticized Phil Gramm fought to limit these CRA requirements in the 1990s, contributing to minimal effect and much political hackling.⁴⁸

The ideological split between these two camps is perhaps best captured by the heated exchange between Dennis Sewell, writing in the October 2008 issue of the *Spectator*, and Roberta Achtenberg, Assistant Secretary for Fair Housing and Equal Opportunity during the Clinton Administration. According to Sewell,

Changes were made to the Community Reinvestment Act to establish a system by which banks were rated according to how much lending they did in low-income neighbourhoods. A good CRA rating was necessary if a bank wanted to get regulators to sign off on mergers, expansions, even new branch openings. A poor rating could be a disastrous for a bank’s business plan.⁴⁹

“At the same time,” Sewell notes, “the government pressed Freddie Mac and Fannie Mae . . . to help expand mortgage loans among low and moderate earners, and introduced new rules allowing the organisations to get involved in the securitisation of subprime loans. The first package was launched in 1997 in collaboration with Bear Stearns.”⁵⁰

Sewell charged that “Ms. Achtenberg . . . was busy setting up a network of enforcement offices across the country, manned by attorneys and investigators, and primed to spearhead an assault on the mortgage banks, bringing suits against any suspected of practising unlawful discrimination . . .”⁵¹ These legal assault teams, according to Sewell, so terrorized the banks with threats of prosecution if they did not meet their CRA quotas, that “by 1995, Achtenberg was actually having to rein in her zealots, issuing a clarification that the use of the phrase ‘master bedroom’ in a property advertisement was, despite its clear patriarchal and slave-owning resonances, not actually an actionable offence under the anti-discrimination laws.”⁵²

⁴⁶ Stan Liebowitz, *The Real Scandal: How Feds Invited the Mortgage Mess*, N.Y. POST, Feb. 5, 2008, http://www.nypost.com/seven/02052008/postopinion/opedcolumnists/the_real_scandal_243911.htm?page=0.

⁴⁷ Editorial, *Review & Outlook: A Mortgage Fable*, WALL ST. J., Sept. 22, 2008, at A22.

⁴⁸ *Id.*

⁴⁹ Sewell, *supra* note 6, at 15.

⁵⁰ *Id.*

⁵¹ *Id.* at 14.

⁵² *Id.* at 15.

William Cohan, citing Sewell in his massive study of the economic crisis entitled *House of Cards*, noted that standing in the way of Achtenberg's mission "were the conservative lending policies of banks, which required such inconvenient and old-fashioned things as cash deposits and regular repayments"⁵³ Accordingly, Sewell is quoted⁵⁴ as saying, "Clinton told the banks to be more creative."

In response to these allegations, Achtenberg responded that "with 'all humility[,]'" as Assistant Secretary of HUD from 1993 to 1995 she was "just a bit player[,]'" and that any deterioration in lending standards "had nothing to do' with her office and she was 'not sure how they came to pass.'"⁵⁵

Nor it seems does anyone else actually connected with the housing collapse. Instead, Achtenberg placed the blame on President George W. Bush, claiming that his American Dream Down Payment Initiative, passed in December 2003, "provided up to \$200 million to encourage home ownership among low-income first-time home buyers by helping to pay closing costs and down payments."⁵⁶

The Sewell–Achtenberg debate is unlikely to be resolved anytime soon, and must therefore be left to the economic historians of the future. For the present, however, what is most disconcerting about the Sewell–Achtenberg debate is not which of the two is more accurate in assessing blame, but rather that the debate itself—inasmuch as it serves as a stand-in for the debate between the two ideological camps—has focused on the causes of the bubble collapse rather than on how the bubble was created in the first place. Without understanding how the bubble was created, no sound policies can be devised for preventing future bubbles and their inevitable collapse.

While lawsuits and prosecutions against those who perpetrated criminal fraud or breach of fiduciary duty remain as entirely appropriate sanctions against guilty parties, the quest for scapegoats guilty of speculation or exhibiting the eternal human characteristic of greed is likely to be self-defeating. From greedy homeowners who sought to take advantage of easy loan terms, to greedy bankers and greedy customers who invested in money-market funds and hedge funds for the high returns gained on highly leveraged CDOs, such a quest is as likely to find a person who was *not* greedy as Diogenes was in his quest to find an honest man.

While it is easy to attribute the housing bubble collapse to greed and speculation, a closer look reveals that these attributions may not be fair in

⁵³ COHAN, *supra* note 3, at 294.

⁵⁴ *Id.*

⁵⁵ *Id.* at 296.

⁵⁶ *Id.*

light of the sixty-seven year bubble in housing prices. When a homeowner in 2006 decided to buy a house using 100% leverage—that is, not making a down payment—the apparent risk did not appear high when one considered that the average price of a house had not declined over a single two-year period between 1950 and 2005.⁵⁷ Human beings cannot generally plan their lives based on the fear of very unlikely events, such as hundred-year floods or thousand-year asteroid hits. If they did, few people would dare to live in California, where every hundred years or so a devastating quake occurs such as the 1906 earthquake in San Francisco. It may, therefore, have been entirely rational for a person to buy a house with no money down in the expectation that a sixty-seven year trend would continue and that equity could be built into the house over time purely through appreciation. Indeed, some of the best and most successful financial planners in the country advised their clients to do so.

Likewise, it cannot really be said that banks were reckless in lending money to homebuyers without requiring a down payment when the sixty-seven year rise in home prices appeared to provide a valid database upon which to evaluate and manage risk. The same can be said for investment banks, hedge funds, or money-market funds that borrowed money at low rates using collateral in the form of CDOs derived from home mortgages, and then lending that money out at higher rates. Indeed, in light of the housing bubble, even politicians might be condoned for winning votes and staying in power by pushing for broader home ownership through expanded lending to marginal borrowers.

Consider the example of a customer who enters a casino with the knowledge that the roulette wheel has hit on red every day of every year for the past sixty-seven years because the government has rigged the roulette wheel to do so. Is it really reckless speculation for the customer to bet on red?

But the arguably rational behavior by homeowners, mortgage lenders, investment bankers, real estate agents, auditors, credit rating agencies, appraisers, and even politicians during the period of bubble expansion does not mean that there is no blame to be found for the housing collapse. Rather, it means that the blame should be focused on those who *created* the bubble, and who recklessly ignored the certainty that all bubbles, like all Ponzi schemes, must ultimately collapse in a catastrophe. To a large extent, that blame brings us back to the politicians—not for causing the collapse directly by sticking the pin into the balloon, but by doing so indirectly by means of blowing the balloon up in the first place. Nevertheless, the blame for creating the bubble is no less well deserved.

⁵⁷ U.S. CENSUS BUREAU, *supra* note 16.

III. CREATING THE BUBBLE

A. Government Housing Subsidies for the Rich and Upper-Middle Class

Bubbles often start slowly and build steam over time. Ironically, the Great American Housing Bubble appears to have begun through an oversight. In 1913, Congress passed the first American income-tax law. Although the act provided for a deduction for interest, it appears that the deduction was intended primarily for business expenses.⁵⁸ However, since the Act did not clearly limit interest deductions to that one purpose, the few homeowners who had mortgages in 1913 began to take advantage of the deduction to deduct the amount paid in interest on their home loans. By means of this Act, the U.S. Government took the first small step toward creating a housing bubble by pumping taxpayer money into the purchase of private homes.⁵⁹ As these tax subsidies continued and compounded every year, over time they contributed significantly to raising the price of houses. In the early years after the passage of the Income Tax Act, however, its effect was limited due to the fact that relatively few American homeowners qualified for home mortgages. In part, this was because most lenders, including the building and loan associations, required at least a 20% down payment, and often as much as 50%.⁶⁰ In addition, building and loan associations' mortgages were generally for terms of no more than eleven years, while insurance companies lent money to homeowners for terms of six to eight years, and banks for terms of two to three years.⁶¹ Nevertheless, even under loan terms that might be considered onerous today, by 1930, almost half of all Americans owned their own homes.⁶²

Although there appears to be a common perception that it was President Roosevelt's New Deal that first fostered the notion of home ownership as a national ideal, it was, in fact, Herbert Hoover who in 1932 pushed through the Federal Home Loan Bank Act of 1932, with the purpose of providing liquidity⁶³ to mortgage lenders, creating a secondary market, and "promoting home ownership."⁶⁴ Roosevelt then did follow up in 1933,

⁵⁸ Chad. D. Emerson, *All Sprawled Out: How the Federal Regulatory System Has Driven Unsustainable Growth*, 75 TENN. L. REV. 411, 427-28 (2008).

⁵⁹ David Leonhardt, *Don't Fear the Bubble That Bursts*, N.Y. TIMES, Mar. 1, 2006, at C1.

⁶⁰ Daniel Immergluck, *Private Risk, Public Risk: Public Policy, Market Development, and the Mortgage Crisis*, 36 FORDHAM URB. L.J. 447, 452 (2009).

⁶¹ Michael J. Lea, *Innovation and the Cost of Mortgage Credit: A Historical Perspective*, 7 HOUSING POL'Y DEBATE 147, 162 (1996), available at [http://www.mi.vt.edu/data/files/hpd%207\(1\)/hpd%207\(1\)%20lea.pdf](http://www.mi.vt.edu/data/files/hpd%207(1)/hpd%207(1)%20lea.pdf).

⁶² See Ernest M. Fisher, *Changing Institutional Patterns of Mortgage Lending*, 5 J. FIN. 307, 307-10 (1950); Immergluck, *supra* note 61, at 453 (citing the actual figure for home ownership at just under 48%, stating that is unlikely that home ownership "hit rates substantially above 50%").

⁶³ DAN IMMERGLUCK, CREDIT TO THE COMMUNITY 36 (Richard D. Bingham & Larry C. Ledebur eds., 2004).

⁶⁴ SUSAN HOFFMAN, POLITICS AND BANKING 160-61 (2001).

with the Home Owners Loan Act,⁶⁵ which purchased loans in default and refinanced loans with more generous terms. This was followed with the National Housing Act,⁶⁶ which created the Federal Housing Administration, extended government mortgage insurance to those who could not raise a 20% down payment, and offered home loans amortized over twenty—later thirty—years. It is this act that is now considered to have laid the foundations for securitization of home loans. This program was extended to veterans by means of VA-guaranteed mortgages, which by 1956 accounted for 35% of new mortgages.⁶⁷

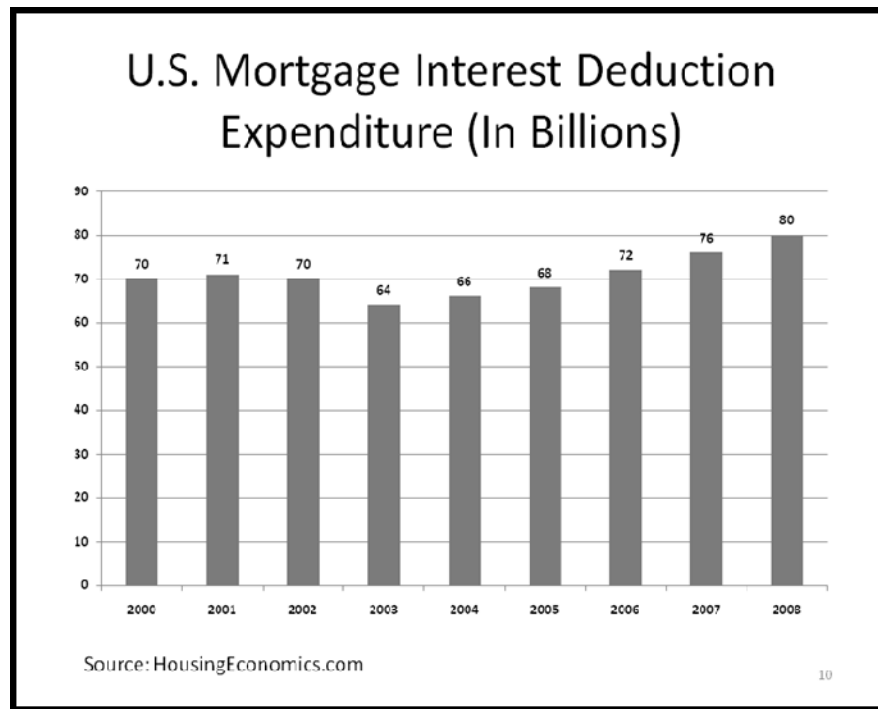
In order to expand the secondary market for mortgages, particularly in the private conventional mortgage market, and provide additional liquidity, in 1938 Congress created the Federal National Mortgage Association⁶⁸ (now nicknamed “Fannie Mae”). With the creation of Fannie Mae, a major step was taken toward mortgage securitization by which loan originators were separated from the servicing and funding aspects of the lending process.

⁶⁵ BRENDA HAUGEN, FRANKLIN DELANO ROOSEVELT: THE NEW DEAL PRESIDENT 67, 69 (Shelly Lyons ed., 2006); *see also* G. H. BENNETT, ROOSEVELT'S PEACETIME ADMINISTRATIONS, 1933-41, at 105 (2004) (“While the creation of a social security system seemed a rather distant hope in the crisis of 1933, Roosevelt did take immediate action to stem the tide of foreclosures on mortgages on people’s homes. Although the Home Owners Loan Corporation lasted only three years, in that time it helped almost a million home owners to retain their homes by refinancing their mortgages.”).

⁶⁶ BENNETT, *supra* note 66, at 111-12 (“In June 1934 the Federal Housing Administration (FHA) was created under the provisions of the National Housing Act. The FHA provided insurance cover for mortgages advanced by private lenders against possible illness and unemployment on the part of the mortgage holder. By 1935 Roosevelt was satisfied that the FHA was doing an effective job in the campaign of his administration for greater social and home security.”).

⁶⁷ Immergluck, *supra* note 61, at 457.

⁶⁸ Fannie Mae, About Us, <http://www.fanniemae.com/about/index.html> (2009).



Although the institution of securitization is now associated most closely with the regulations promulgated in the mid-1990s under the Clinton Administration, which “opened the floodgates” of that process and worked with Bear Stearns to expand it broadly to the private investment sphere,⁶⁹ the most important early steps in the process were undertaken by Fannie Mae and her little brother Freddie Mac.⁷⁰ Nevertheless, the percentage of securitized home loans rose from 54% in 2001 to 75% in 2006⁷¹ in the aftermath of the Clinton regulations.

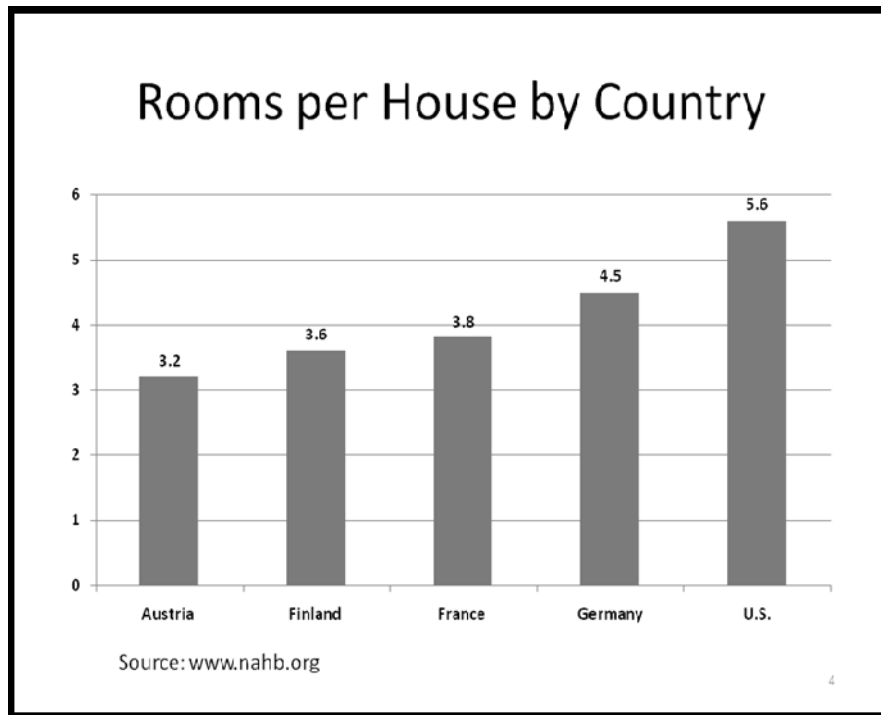
By using the tax system to funnel vast sums of U.S. investment capital to housing from other sectors of the economy, the politicians and policy makers have made a conscious decision to elevate housing above all other forms of investment. Despite such an extreme distortion in investment

⁶⁹ F. William Engdahl, *The Financial Tsunami Part IV: Asset Securitization – The Last Tango*, Feb. 8, 2008, http://www.engdahl.oilgeopolitics.net/Financial_Tsunami/Asset_Securitization/asset_securitization_the_last_HTML.

⁷⁰ Scott Frame & Lawrence J. White, *Fussing and Fuming over Fannie and Freddie: How Much Smoke, How Much Fire?*, 19 J. ECON. PERS., Spring 2005, at 159, 179 (discussing Freddie Mac and Fannie Mae's involvement in securitization: “As an historical matter, Fannie Mae and Freddie Mac have surely enhanced the liquidity of mortgage loans, improved the geographic diversification of mortgage credit risk, and nationally integrated mortgage markets. Further, the presence of Fannie Mae and Freddie Mac and their implied guarantees may well have been important for the innovation and development of mortgage securitization in the 1970s and 1980s.”).

⁷¹ Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis* 31-32 (Dec. 5, 2008) (unpublished draft, on file at <http://ssrn.com/abstract=1020396>).

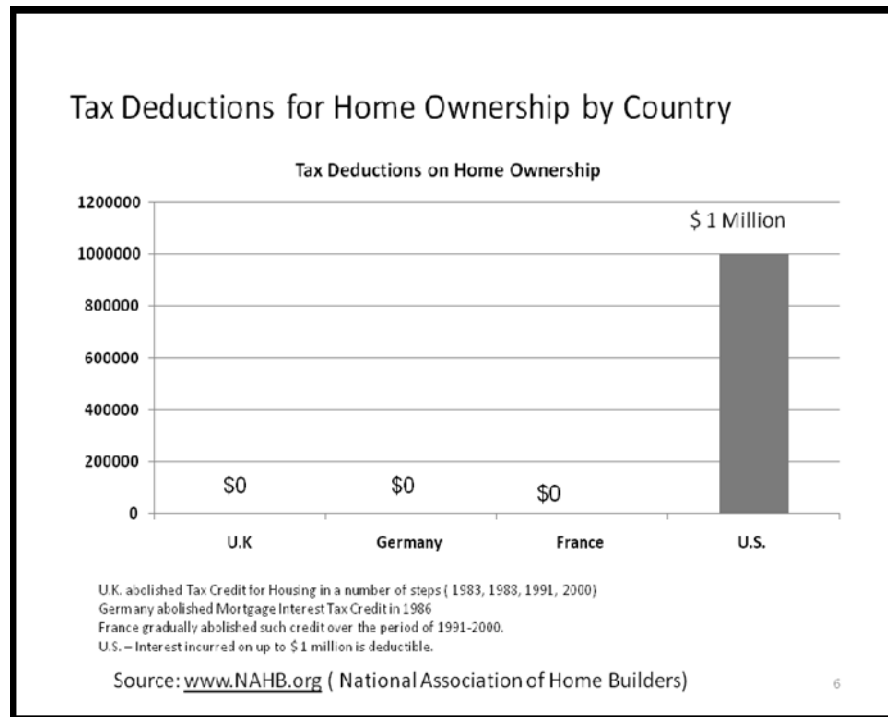
patterns, such a policy of fostering a housing bubble by inflating prices could conceivably have been justified if home ownership rates reflected the intent of such a policy. This has hardly proven to be the case, however. For example, while the U.S. income-tax code permits homeowners to deduct the interest on up to one million dollars of mortgage debt, income tax codes in countries such as the U.K., Germany, and France, permit no such deductions at all;⁷² yet home ownership rates in the U.K. exceed 71% compared to home ownership rates of 69% at the height of the U.S. housing bubble (before falling to 67.3% in the aftermath of the housing collapse).⁷³ Even Greece has considerably higher home ownership rates than the U.S. at 85%.⁷⁴



⁷² Tiffany Chaney & Paul Emrath, US vs. European Housing Markets (May 5, 2006), HousingEconomics.com, <http://www.nahbregistration.com/generic.aspx?sectionID=734&genericContentID=57411&channelID=311>.

⁷³ U.S. CENSUS BUREAU, CB09-104, CENSUS BUREAU REPORTS ON RESIDENTIAL VACANCIES AND HOMEOWNERSHIP 1 (2009), available at <http://www.census.gov/hhes/www/housing/hvs/qtr2009/files/q209press.pdf>.

⁷⁴ Chaney, *supra* note 73.



Perhaps the most pernicious aspect of this government policy of subsidizing investment in homes is that it is lavished primarily on the rich and upper-middle class.⁷⁵ One-third of Americans cannot afford to buy a house at all,⁷⁶ and of the remaining two-thirds who do own homes, over half of them do not qualify for the home-mortgage deduction because it does not exceed their standard deduction.⁷⁷ That leaves the remaining top third of American income earners to feast on the most extravagant government handouts, and enables them to accumulate wealth unattainable by the bottom two-thirds ineligible for such subsidies. Not surprisingly, the size of houses in the U.S. has increased dramatically since the institution of directing the lion's share of the home mortgage deduction to the rich—from an average size of 950 square feet in 1900, to a more princely 2,436 square feet in 2005.⁷⁸ During the same period, the number of rooms per house has also increased to 5.6, compared to countries like Austria, which makes do with 3.2, and France, which makes do with 3.8.⁷⁹ Although data is not available showing the average square feet of houses owned by those who get the

⁷⁵ See Lowenstein, *supra* note 5 (“[T]he U.S. should scrap the mortgage-interest deduction and replace it with a smaller tax credit, available to every homeowner.”).

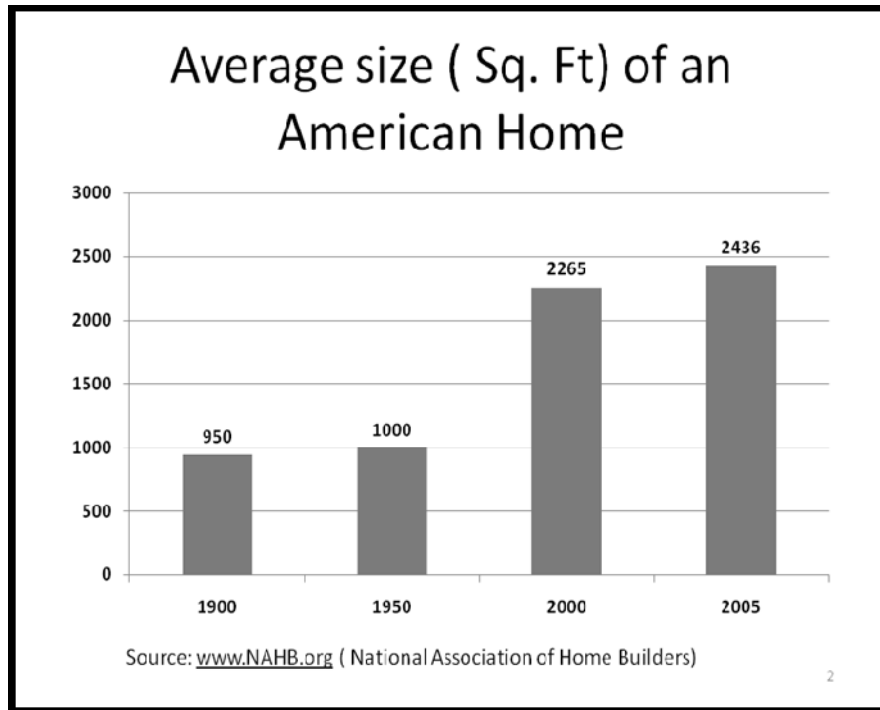
⁷⁶ Thomas J. Sugrue, *The New American Dream: Renting*, WALL ST. J., Aug. 15, 2009, at W1.

⁷⁷ I.R.S., PUBLICATION 936, HOME MORTGAGE INTEREST DEDUCTION 8 (2008).

⁷⁸ See *infra* graph “Average size (Sq. Ft.) of an American Home.”

⁷⁹ Chaney, *supra* note 73.

highest tax deductions, it is not difficult to determine from available data that the rich have enjoyed the greatest increase in living space as a result of the government largess lavished on them.

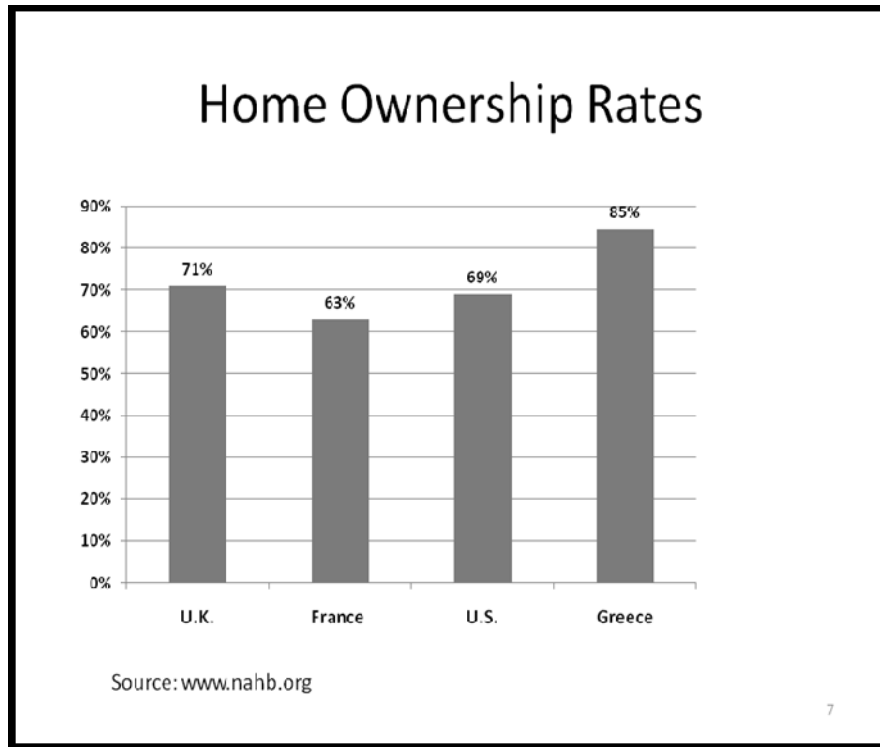


By 1984, the accidental origins of the home-mortgage deduction was largely forgotten, and many politicians simply assumed that tax subsidies for the rich to buy houses had always been part of an American dream to own big houses. As Ronald Reagan proclaimed in that year, “we will preserve the part of the American dream which the home-mortgage-interest deduction symbolizes.”⁸⁰

By 1997, those receiving the biggest home mortgage deductions began to complain that the huge windfalls they enjoyed from appreciation of their houses were taxable under the capital gains rules. To cater to these complaints, Congress passed the Taxpayer Relief Act of 1997, which waived even the low capital gains taxes on the sale of homes up to a half-million dollars, thus contributing to house inflation by making homes even more attractive as an investment vehicle for speculators and wealthy

⁸⁰ Press Release, Danilo Pelletiere, Research Dir., Nat'l Low Income Hous. Coal., Mortgage Interest Deduction (May 6, 2009) (available at http://www.nhtf.org/detail/article.cfm?article_id=6061&id=46) (“I want you to know that we will preserve the part of the American dream which the home-mortgage-interest deduction symbolizes.”).

Americans seeking a reliable tax haven.⁸¹ By 2002, the myth of the American dream had become political orthodoxy, as President George W. Bush proclaimed official-government policy: “[W]e want *everybody* in America to own their own home.”⁸²



B. Local Government Exclusionary Policies

It is axiomatic that prices are determined not only by demand, but also by supply. Accordingly, the “supply-restriction” effects of local government regulations on home prices must be considered in addition to the “demand-push” effects of government-tax subsidies.

The origins of the exercise of local government control over housing supply can be traced to the 1926 Supreme Court decision in *Village*

⁸¹ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 app.).

⁸² George W. Bush, President of the U.S., President Bush’s 2002 Speech at the Conference on Minority Home Ownership, George Washington University (Oct. 15, 2002), <http://www.freerepublic.com/focus/f-news/2094023/posts> (emphasis added); see also George W. Bush, President of the U.S., Remarks by the President on Homeownership at the Department of Housing and Urban Development, Washington, D.C. (June 18, 2002), <http://www.hud.gov/news/speeches/presremarks.cfm> (“I believe when somebody owns their own home, they’re realizing the American Dream.”).

of *Euclid v. Ambler Realty Co.*,⁸³ which gave constitutional sanction to the power of local governments to enact exclusionary zoning restrictions to promote the property interests of members of their own communities, often at the expense of others.

An example of the effects of the exercise of such powers was revealed in a recent study of the outer areas of the Washington, D.C. metropolitan area.⁸⁴ According to the study, more than half the land in the outer areas of D.C. is subject to zoning restrictions requiring lot sizes of between three and twenty-five acres of land.⁸⁵ Such policies work well to protect the land values of current homeowners by insuring that multi-unit dwellings are kept far away from wealthy estates, but inevitably, result in urban sprawl located further and further from the urban core while restricting the number of affordable housing units within reasonable commuting distance from offices and working areas.

Perhaps the most insidious aspect of such regulations is that they are justified on⁸⁶ grounds of “saving farmland, forests, and meadows,” when in fact they serve primarily to restrict the supply of homes within reasonable commuting distances. By so doing, the regulations preserve and even enhance the prices of homes currently inhabited by those wealthy enough or influential enough to control the promulgation of zoning ordinances through local city councils, zoning commissions, and other local governmental entities.

Peter Whoriskey’s study titled *Density Limits Only Add to Sprawl*, revealed quite clearly that such exclusionary practices have “accelerated the consumption of woods and fields and pushed developers outward in their search for home sites.”⁸⁷

Because such local exclusionary policies can significantly limit the supply of houses available for sale within a community, it is easy to see the effect of such restriction of supply on the inflation of housing prices. Ironically, it is often the communities in states which purport to espouse progressive policies that are guiltiest of implementing the most exclusionary zoning restrictions—such as California.⁸⁸ In Boulder, Colorado, lot-size requirements⁸⁹ ensure that only those able to afford the most expensive lots and houses can live in the city, while also placing pressure on prices by restricting the total supply of houses within the city. In such settings,

⁸³ Vill. of *Euclid v. Ambler Realty Co.*, 272 U.S. 365 (1926).

⁸⁴ Edward H. Ziegler, *The Case for Megapolitan Growth Management in the 21st Century*, 41 URB. LAW. 147, 147-48 (2009).

⁸⁵ *Id.* at 160.

⁸⁶ *Id.*

⁸⁷ Peter Whoriskey, *Density Limits Only Add to Sprawl*, WASH. POST, Mar. 9, 2003, at A1.

⁸⁸ *Constr. Indus. Ass’n of Sonoma County v. City of Petaluma*, 375 F. Supp. 574, 583 (N.D. Cal. 1974), *rev’d*, 522 F.2d 897 (9th Cir. 1975).

⁸⁹ *Id.* at 584.

wealthy homeowners are permitted to increase their wealth exponentially by riding on a wave of concerns about the environment.

One prominent example of such wealth-enhancement strategies is that set forth in the case of *Construction Industry Ass'n of Sonoma County v. The City of Petaluma*.⁹⁰ In that case, the City of Petaluma passed an outright freeze on all development on grounds that such a measure was justified on environmental grounds.⁹¹ The Ninth Circuit agreed, upholding the measure as a means to “preserve its small town character, its open spaces and low density of population, and to grow at an orderly and deliberate pace.”⁹²

Since that case, however, there has emerged a growing cynicism and skepticism regarding the true motives behind those who use their power to implement exclusionary regulations. James Clingermayer, for example, has observed that, despite claims of acting in the interest of the environment, such practices are now widely associated with high “home values, income levels, and [preservation of the] white population”⁹³ Mark Baldassare, in *Trouble in Paradise: The Suburban Transformation in America*,⁹⁴ has observed that lawyers representing rich homeowners engaging in exclusionary practices have now learned to give environmental concerns as a reason for upholding those practices.

Nevertheless, a few courts have begun to see through the attempt by wealthy homeowners to increase their wealth under a banner of concern for the environment. In *Woodwind Estates, Ltd. v. Gretkowski*, for example, the court recognized that the real basis for a city’s exclusionary zoning was concerns “about the socioeconomic background and income-levels of prospective tenants”⁹⁵

A journalist reporting on this case has observed:

While trying to develop affordable homes and bring the American dream of homeownership to an expanded class of citizens, Woodwind Estates ran smack into the NIMBY (not-in-my-back-yard) syndrome. Neighbors of the proposed project didn’t like the idea, at least, not in their neighborhood. Banding together (as such groups always do) . . . the Concerned Neighbors of Woodwind Estates . . . sought to stop the project by peppering the Stroud

⁹⁰ See *Constr. Indus. Ass'n of Sonoma County v. City of Petaluma*, 522 F.2d 897, 908-09 (9th Cir. 1975).

⁹¹ *Id.* at 901.

⁹² *Id.* at 909.

⁹³ James C. Clingermayer, *Quasi-Judicial Decision Making and Exclusionary Zoning*, 31 URB. AFF. REV. 544, 549 (1996).

⁹⁴ MARK BALDASSARE, *TROUBLE IN PARADISE: THE SUBURBAN TRANSFORMATION IN AMERICA* 20 (1986).

⁹⁵ *Woodwind Estates, Ltd. v. Gretkowski*, 205 F.3d 118, 125 (3d Cir. 2000).

Township Planning Commission with euphemisms. They were concerned about the income level of potential residents, as well as their socioeconomic background. Fretting about the effect of such people on local property values, they urged project denial simply because they were opposed to low-income residents moving into their community.⁹⁶

In other words, many local governments' idea of environmentalism is simply to keep the "riff raff" out—or at least as far away as possible. Little consideration is given to where the "riff raff" will have to go. Dan Silver, head of the Los Angeles based Endangered Habitats League, has considered this question, however, and concluded that "rather than preventing growth, the traditional anti-sprawl lawsuit simply diverts development into another neighborhood or outer suburbs."⁹⁷

Although some developers valiantly resist such exclusionary policies, in the end, few have the time or resources to engage in costly litigation with wealthy and powerful homeowners and homeowners' groups eager to enjoy the windfall profits they stand to gain by restricting the supply of houses in their communities. Most simply move and let incumbent homeowners enjoy the fruits of the exclusionary policies.

Although the economic consequences of local exclusionary policies—and in particular the effects of those policies on the creation of the housing bubble—are considerable, the social and true environmental consequences should also be noted. As those who work in a metropolitan area are driven further and further out in order to find affordable housing, commuting times expand exponentially, contributing to the nearly three million automobile deaths since 1900⁹⁸, or the equivalent of a 9/11 attack every month. Professor Edward Ziegler's massive study of urban sprawl has concluded that such sprawl "increases air and water pollution" and "increases the consumption of oil and the emission of green house gases from automobiles," and concludes:

[c]ities that tout their Green Development initiatives . . . should be honest enough to count their 'zoning policy' responsibility for their 'exclusion-driven GHG emissions' from the automobile driving of workers in the city who must find housing elsewhere and from their own city residents who need to drive elsewhere to find jobs.⁹⁹

Meanwhile, as these exclusionary policies push more and more

⁹⁶ Michael Berger, *Building Blues*, L.A. DAILY JOURNAL, May 3, 2001, at 7.

⁹⁷ Ziegler, *supra* note , at 161.

⁹⁸ NEW YORK TIMES ALMANAC 2002, at 382 (John W. Wright ed. 2002).

⁹⁹ *Id.* at 161, 158.

people into the hinterlands, forests and rainforests are now being destroyed at the rate of 100 acres per minute.¹⁰⁰ To provide living space for them, one entire living species is sacrificed every day, including the extinction of one vertebrate species every nine months.¹⁰¹

*C. Promulgation of Misleading Government Statistics*¹⁰²

In 1983, the Bureau of Labor Statistics (“BLS”) was faced with an awkward dilemma. If it continued to include the cost of housing in the Consumer Price Index (“CPI”), the CPI would reflect an interest rate of 15%, thereby making the country’s economy look like a banana republic. Because bondholders have traditionally demanded a 2% real return, that would mean bond and money-market yields could have climbed as high as 17%.

In order to camouflage the rapid and dangerous expansion of the nation’s housing bubble as well as deceive investors as to the country’s real inflation rate, the BLS came up with an ingenious solution that was as simple as it was deceptive: exclude the cost of housing as a component in the CPI, and substitute a so-called “Owner Equivalent Rent”¹⁰³ based on how much a homeowner might rent his house.

The result of this statistical sleight of hand was immediate and gratifying for government-policy makers—the reported inflation rate quickly dropped to two percent.¹⁰⁴ Government policy makers even got an added bonus: because a rapid rise in housing prices attracts speculators who must rent out their houses during the period in which they hold, as the rental market is flooded with this new supply, rent prices often fall even while house prices rise. This put an even more downward bias pressure on the reported CPI according to the Owner Equivalent Rent factor.

With the dangerous expansion of the housing bubble thus suitably camouflaged, government-policy makers were now free to adopt other

¹⁰⁰ ROBERT M. HARDAWAY, *POPULATION, LAW, AND THE ENVIRONMENT* 17 (1994) (citing PHILIP HURST, *RAINFOREST POLITICS: ECOLOGICAL DESTRUCTION IN SOUTH-EAST ASIA* viii (1990)).

¹⁰¹ *Id.* (citing DANIEL D. CHIRAS, *ENVIRONMENTAL SCIENCE: ACTION FOR A SUSTAINABLE FUTURE* 5 (3d ed., Benjamin-Cummings Publishing 1991)).

¹⁰² Robert M. Hardaway, *Price Index Sleight of Hand Haunts in Credit Crisis*, ROCKY MOUNTAIN NEWS, Sept. 22, 2007, at B2, available at http://www.rockymountainnews.com/drmn/other_business/article/0,2777,DRMN_23916_5704327,00.html#. This section is adapted from author Robert Hardaway’s article.

¹⁰³ BUREAU OF LABOR STATISTICS, *HOW THE CPI MEASURES PRICE CHANGE OF OWNERS’ EQUIVALENT RENT OF PRIMARY RESIDENCE (OER) AND RENT OF PRIMARY RESIDENCE (RENT)* 1 (2009), available at <http://www.bls.gov/cpi/cpifacnewrent.pdf> (“Housing units are not in the CPI market basket. Like most other economic series, the CPI views housing units as capital (or investment) goods and not as consumption items. Spending to purchase and improve houses and other housing units is investment and not consumption. *Shelter*, the service the housing units provide, is the relevant consumption item for the CPI. The cost of shelter for renter-occupied housing is rent. For an owner-occupied unit, the cost of shelter is the implicit rent that owner occupants would have to pay if they were renting their homes.”).

¹⁰⁴ Hardaway, *supra* note 103.

policies that contributed toward the creation of the housing bubble.

D. Government Policies Directed Toward Expanded Lending to Marginal Buyers

The current debate over the role of government policies directed toward pressuring banks to lend to marginal borrowers was discussed in Part II with the acknowledgment that resolution of this debate is best left to future economic historians. An entirely different question is the role of such policies in creating the housing bubble. Though a smoking gun is unlikely to be found, the fact remains that the rate of home ownership in the U.S. did increase from about 65% to 68-69% in the aftermath of the Clinton Regulations.¹⁰⁵ These regulations put teeth into the CRA by means of active and vigorous enforcement of provisions for very real punishments to be meted out to those lenders failing to meet quotas for lending to certain categories of marginal buyers.¹⁰⁶ What the bubble collapse revealed, however, was that a high percentage of those who made up that 3-4% increase in home ownership were unable to afford the homes they purchased.¹⁰⁷ This raises the question as to whether government policies geared toward ensnaring this additional 3-4% of the population into highly leveraged and risky home ownership was worth the economic fallout when the housing bubble inevitably collapsed.

E. Government Policies of Easy Money at the Peak of the Housing Bubble

The final stages of the housing bubble had the misfortune of occurring in the aftermath of the dot-com and stock market crash of 2000–2001. Panicked regulators, including the Chairman of the Federal Reserve, desperate to fend off recession, reacted with low interest rates, apparently in the belief that such low rates could be implemented without concern for building yet another dangerous bubble in the housing sector. The reckless reduction in the federal fund rates from 6.5% in 2000 to 1% in 2003¹⁰⁸ proved to be the trigger for finally blowing the top off the housing bubble. At 1% federal fund rates (translated into adjustable mortgage rates as low as 3-4%), millions of marginal borrowers appeared to qualify for making monthly payments on ever bigger and more extravagant houses. Tantalized by the possibility of buying a house they could never have dreamed of buying before, many of these borrowers conveniently ignored the

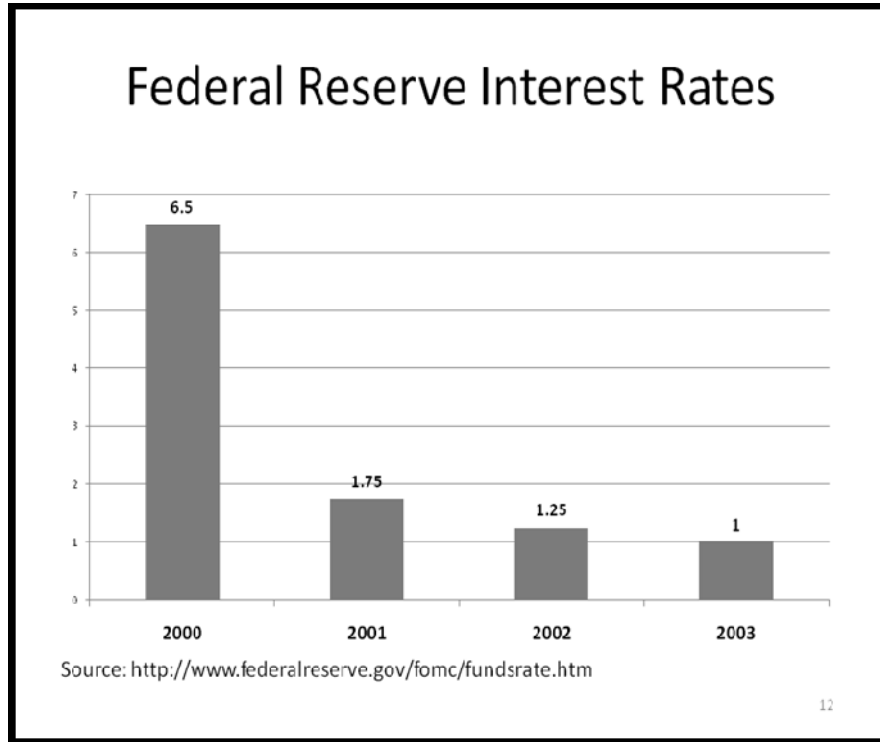
¹⁰⁵ White House Press Briefing, *supra* note 18.

¹⁰⁶ TRAIGER & HINCKLEY, LLP, THE COMMUNITY REINVESTMENT ACT: A WELCOME ANOMALY IN THE FORECLOSURE CRISIS 4 (2008), available at http://www.traigerlaw.com/publications/traiger_hinckley_llp_cra_foreclosure_study_1-7-08.pdf.

¹⁰⁷ Raphael W. Bostic & Kwan Ok Lee, *Mortgages, Risk, and Homeownership Among Low- and Moderate-Income Families*, 98 AM. ECON. REV. 310, 310-14 (2008).

¹⁰⁸ Fed. Reserve Bd., Open Market Operations, <http://www.federalreserve.gov/fomc/fundsrate.htm> (last visited Nov. 11, 2009).

possibility—indeed probability—that these rates might soon adjust upwards to levels they could not afford.



IV. CONCLUSION

The majority of studies, books, and articles purporting to explain and attach blame for the housing collapse have failed to distinguish between causes and effects. These studies have well documented the role that overextended homeowners, greedy Wall Street financiers and investment banks, compromised realtors, accountants, credit rating agencies, and ineffective and inattentive regulators have all played in the housing collapse. It is herein submitted, however, that these factors were the result of the housing bubble itself, and not the cause of the housing bubble collapse.

Homeowners overextended themselves because they rationally assumed that home prices would continue to rise as they had done for the past sixty years due to government policies of subsidy and exclusion and that anticipated increases in the value of their home would substitute for the up-front equity that a down payment would ensure.

Lenders too, all along the long chain from home buyer to originator to the investor in securitized debt obligations, were rational in investing in

the closest thing to a sure thing ever offered up by government since the introduction of savings bonds, though with a far-higher rate of return.

In addition, investment bankers were not irrational in leveraging at one hundred to one in making a market in CDOs, given that the underlying asset upon which securitized debt obligation was based had not declined in sixty-seven years. Likewise, the money market managers, the hedge-fund managers, and investors in the financial instruments derived from the underlying asset of the home acted rationally.

In short, all these suspected culprits in the collapse of the housing bubble were not more greedy, irrational, or inclined toward reckless speculation than the denizens of San Francisco who are perfectly willing to rely on the fact that no major earthquake of 1905 proportions has occurred in the last one hundred and four years; or the denizens of New Orleans that no seventy-year hurricane will occur in the near future, or even in their lifetime—and they are staking far more than the investors in CDOs.

Rather, all these activities engaged in by these suspected culprits flowed rationally from the very fact that a housing bubble had been created. The real culprits are those who created the bubble.

Current government policy is to repeat the mistakes of policy makers during the Great Depression, when it was thought that the best remedy for deflation was to keep prices high by such strategies as destroying crops to restrict supply. Vestiges of this thinking can be seen today in the “Cash for Clunkers”¹⁰⁹ program and tax legislation awarding up to \$8,000 to those who want to buy a house.¹¹⁰

Rather than try to “keep the bubble going,” policy makers should adopt policies that would prevent a future bubble from occurring. This can best be done by eliminating home mortgage tax subsidies for the richest Americans, repealing laws pressuring banks to extend mortgages to marginal buyers, and prohibiting the practice of local exclusionary practices.

¹⁰⁹ Hardaway, *supra* note 39.

¹¹⁰ American Recovery and Reinvestment Act of 2009, 123 Stat. 225.

