

Achieving the
American dream





The affordability of homeownership for middle-income Americans



First there was 123rd Terrace. Then South Hawthorne Avenue, followed by West 5th Street. And now Spalding Drive.

This summer, as Ray Anderson moves into what probably will be the last house he ever lives in, he leaves behind a home for each stage of his life. Now, semi-retired and a grandfather, 59-year-old Anderson and his wife, Beth, recently purchased a home in Bella Vista, Ark. It's a one-story, newer house with upgrades, like granite countertops and a whirlpool tub, near a golf course. It's much different than any of the other homes he's purchased, especially the first one.

In 1981, when Anderson was 31 with two young daughters, he and his first wife saw many of their friends buying houses. They, too, were tired of renting. At 12 percent, interest rates were more than double today's rate, and it took the young family a couple years to "scrape together" a down payment of 5 percent. But they were able to purchase a two-story,

three-bedroom townhouse for \$45,000 in Olathe, Kan.

"That was about the maximum we could afford," says Anderson, remembering how proud the family was to be a part of the American dream. "It was nice to actually own a house."

These sentiments are echoed by homeowners everywhere. But during the past several decades, buying a house has been perceived as more and more difficult, says Jordan Rappaport, senior economist at the Federal Reserve Bank of Kansas City. He recently researched home affordability, comparing the cost of homeownership with household income from 1971 to 2007—prior to the fallout from the current housing crisis.

"As housing prices climbed, many people complained that housing has become unaffordable to middle-income Americans," Rappaport says. "As early as 1998, homeownership was commonly perceived to be a heavy and growing financial burden. When

the rise in home sales prices peaked in 2006, homeownership was increasingly thought of as the unattainable American dream.”

Despite these concerns, homeownership actually increased from the mid-'90s, hitting its highest level ever in 2004, though the recent surge in foreclosures suggests many households bought homes they couldn't afford.

“Still, this doesn't necessarily mean that the same type of housing that middle-income earners purchased back in the '70s is unaffordable for today's middle-income,” he says.

Why the perception that homeownership has become unaffordable? Rappaport says there are several reasons.

- Increased home prices: The national sales price of a constant size and quality house nearly doubled from '71 through mid-'07 (controlling for inflation).

- Larger, higher quality homes: Households increasingly have chosen to buy bigger houses with more amenities, increasing their financial burden.

- Slow income growth: Although household income grew from '71 to '07, it grew much slower than during the 1950s and '60s.

- Increase in associated payments: Required payments grew more quickly than after-tax household income from '71 to '07. This means the estimated housing share of expenditures increased, implying a decrease in affordability.

“However,” Rappaport says, “what people might not be considering is their residual income, which is the amount leftover after the mortgage and housing related-expenses, such as taxes and insurance, are paid. This has gone up, albeit slowly.”

His research shows the rise in after-tax income from '71 to '07 offset the rise in required payments. A median household's real, after-tax income increased \$13,600 between '71 and '07, compared to an average increase of \$7,800 in required payments per year for a comparable house. This shows improved affordability.

The increase in residual income from '71 to '07 can be explained, in part, by a

RAY AND BETH ANDERSON pack their belongings as they prepare to move from Concordia, Kan., to Bella Vista, Ark., this summer. The couple has purchased several homes in their lifetime, but think their newest one also will be their last.



sharp increase in women in the workforce. This also may be a reason why house size and quality, and therefore the financial burden, have increased in recent decades. With two incomes, a household is more likely to be able to afford surround-sound systems or a three-car garage. Furthermore, the perception of housing unaffordability, at least until recently, isn't quashing the American dream, Rappaport says.

Components of affordability

Often consumers want more house than they can really afford, says Paul Roth, a real estate agent in Omaha.

During this past decade "there were very few people downsizing," Roth says. "People were really stepping up—bigger homes and nicer neighborhoods."

Homebuyers wanted finished basements, big yards and sprawling "McMansions." Now, as the global recession continues, many want small, one-story homes. They are willing to cut back on size, but still want high-end amenities in their homes, he says.

Kelly Edmiston, a senior economist at the Kansas City Fed who specializes in community development, says the reasons people want ever-higher quality homes may include rising household incomes, often due to both spouses working, as well as the expectation of significant home price appreciation. Another important element was, until recently, the easier availability of credit such as lower down payments.

In Omaha, home purchases have been steady overall. Roth hasn't seen a dramatic decline in buying during this economic downturn, and throughout his 14-year career in real estate, Roth says he's generally seen "incredible increases in homeownership."

When people aren't buying homes, Roth says it's not because house prices are too high relative to their income, but rather they can't get financing for reasons unrelated to income and price, such as a poor credit history.

"There are homes in all price ranges," Roth says.



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ALTHOUGH HOMEOWNERSHIP HAS INCREASED through the years and hit its highest level ever in 2004, middle-income Americans commonly perceived homeownership to be less attainable in recent years. Research shows this is not necessarily true.

In his research, Rappaport represents "middle income" as the median income in households headed by a married couple with two children. Such a household, like all households, divide their income among purchasing housing, non-housing expenses and saving.

Being "middle income" has fluctuated widely since the early 1970s, Rappaport says. From '71 to '07, median after-tax real income of middle-income households grew by just less than 1 percent annually. It fell from a peak of \$44,000 in 1978 to \$37,000 during the 1982 recession and then slowly rose to \$55,000 by 2007.

House sales prices are the most visible determinant of required house payments. Others include mortgage interest rates, taxes, insurance and maintenance. From '71 to '07, U.S. house prices grew by an annual average rate of 1.7 percent. (In 2007 dollars, the price of a representative 2006 house increased from \$107,000 to \$199,000 from '71 to '07.)

"The total required payments associated with homeownership stood near a historic

high in 2007,” Rappaport say. “But this doesn’t necessarily imply that housing had become less affordable. There are several factors that have improved affordability.”

Houses are almost always purchased with borrowed money, which implies owners need to save for a down payment. Numerous anecdotes show down payments have declined nationwide in the last two decades or so from 20 percent to 10 percent.

Additionally, the mortgage component of required payments is highly sensitive to interest rates, Rappaport says. Interest rates on a fixed 30-year mortgage have varied since the early ’70s, hitting extreme highs in the early and mid-’80s but falling since then, which has helped lower mortgage payments.

that homeowners were becoming worse off,” Rappaport says.

Determining affordability requires comparing required payments with household resources. Between ’71 and ’07, the share of income required for a representative house rose significantly, which is often interpreted as a decline in affordability. But this ratio of payments to income doesn’t reflect how well off households are; a better measure is the difference between resources and payments.

Rappaport’s research shows the income left over after paying for housing was higher in 2007 than in 1971. So even though homeownership became more expensive, it did not become less affordable.

“The ‘share of the pie’ going to housing has

“ The increase in homeownership has more to do with access to financing than to the sale price of homes. ”

Blake Heid, president and CEO of First Option Bank, has seen through the years how a lower percentage down payment and lower mortgage interest rates are advantageous to homebuyers. First Option, which has five locations in eastern Kansas, does a significant amount of home financing.

“Homeownership really exploded,” Heid says. “We’ve also watched the cost of homes continue to rise. ... The supply grew because people could afford to buy a house.”

Edmiston, the Kansas City Fed’s community development economist, agrees these components have affected home buying.

“The increase in homeownership has more to do with access to financing than to the sale price of homes,” he says.

Determining affordability

“Complaints that homeownership was impoverishing households may have arisen from the mistaken belief that an increasing ratio of house payments to income meant

increased,” he says, “but more ‘pie’ was left over after meeting housing expenses. Households were actually better off in 2007.”

However, Rappaport says, households’ sense of well-being may depend in part on their comparison between actual and expected circumstances. When income grew considerably slower than expected between ’71 and ’07, there was disappointment. Even though households were able to increase their consumption of both housing and non-housing goods, they had expected to do so by even more.

There are many factors that affect affordability, such as housing location, size and amenities. These attributes, and others, determine quality, and higher quality implies higher payments and lower affordability.

Quality may in fact be contributing to the perception of unaffordability, Edmiston says. Homes are more expensive, but are of higher quality than in the past.

“There’s a demand for it. People think

bigger is better. People think more is better,” Edmiston says. “They have to pay for that, but regardless, people see prices. And they’ve seen home prices going up.”

Average house quality has greatly improved over time. For example, the median square footage of a newly constructed single-family house rose 60 percent from '71 to '07. Measuring housing quality (including its location) is difficult because many attributes are not easily quantifiable. However, quality and selling price are closely linked, Rappaport says.

Longtime homeowner Ray Anderson knows this to be true. In his lifetime, he’s purchased four homes (plus another as a rental), and each purchase was a little easier than the one prior.

Twenty-eight years after first becoming a homeowner, Anderson is finalizing the home buying process again as he and Beth box up their belongings, maybe for the last time.

“We don’t foresee moving again.”

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BY BRYE STEEVES, SENIOR WRITER

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By Jordan Rappaport
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Update:

U.S. housing sector

Homes in rural America faring better

While the U.S. housing sector overall remains weak—initial construction of U.S. homes and building permits both sank to record lows in the spring—there may be a silver lining.

Research shows rural housing markets haven’t taken quite the hit that metro home values have, says Chad Wilkerson, an economist and Branch executive of the Kansas City Fed’s Oklahoma City office, who recently researched the housing market in rural America.

“Home prices in rural areas have outperformed home prices in metro areas in all regions of the country,” Wilkerson says.

There are several reasons for this:

- The lower gains in housing values were more in line with rural income growth than metro areas.
- Recent new home construction has slowed more sharply than in metros, helping to lower the number of unsold homes.
- Rural economies have been boosted by strong activity in the energy and agriculture sectors.
- Rural employment has grown while the country’s overall job growth has slowed.
- Rural home price gains largely stayed in line with recent historical averages (because of greater land availability and stricter lending standards), resulting in less of a boom and bust.

“Rural America was largely bypassed by the national home price boom of the first half of this decade and seems likely to avoid much of the correction in home prices that’s now underway,” Wilkerson says. “Those home values are not risk-free, though. The slowdown in rural economic growth could threaten home values.”

Looking ahead, Wilkerson says future home price declines in rural areas likely will be much less severe than in metro areas, but at the same time, probably won’t rise much either. The fall in commodity prices at the end of last year means slower economic growth and, in turn, less demand for housing.

“IS RURAL AMERICA FACING A HOME PRICE BUST?”

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