Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

Housing: Sacred Cow?

Some sacred cows will have to be slaughtered in the lean years looming ahead, and housing-industry leaders are beginning to realize that they may provide one of the more tempting targets in this regard. *Business Week*, in a recent editorial, put the problem in these terms: "The diversion of capital from industry to housing—the primary aim of government policy—is one of the reasons investment in productive facilities has been inadequate." And its prescription was forthright: "Wean the housing industry of continuing government assistance and make it stand on its own feet."

The genesis of this viewpoint is a growing body of evidence that inflation and tax policy have caused an over-allocation of resources to the housing sector over the last decade. As the nation enters the 1980's with the goal of expanding the energy and defense industries and "reindustrializing" the economy, the pressure to redirect resources to these sectors will increase. Policies that are designed to promote housing activity at the expense of other sectors are thus likely to come under increasing scrutiny.

The causes

The argument that the housing sector was overemphasized during the last decade rests on a number of factors. First, tax policy treats homeownership relatively favorably. Homeowners can deduct all interest payments from taxable income. They also benefit from their ability to sell their homes without paying capital-gains taxes on the proceeds (provided another home is purchased), and to take out $100,000 in capital gains after the age of 55 without paying any tax at all. In contrast, capital-gains proceeds from financial investments (such as stocks and bonds) *are* taxed, albeit favorably relative to wage and salary income.

In addition, homeowners are not taxed on the "implicit" income they enjoy from an investment in a house in the form of the services that the housing provides them. A $100,000 investment in bonds, for example, provides benefits to the holder of the bonds in the form of interest payments, which would be taxable as income. The same $100,000 invested in a home also provide benefits; but because these are in "kind" rather than in cash, they are not taxed. This, too, is a special tax advantage that housing (and other consumer durables) enjoy.

The second major factor affecting the housing equation is inflation. During the late 1960's and throughout the 1970's, inflation has been steadily on the rise, and households thus have continuously revised upward their expectations of future inflation. It has been rational, therefore, for households to expect substantial capital gains to accrue to all real assets, including housing.

These two factors have combined to make ownership of housing particularly attractive for American households. Expectations of higher rates of inflation bring visions of large (and tax-free) capital gains, thereby lowering the perceived cost of housing. Of course higher inflation expectations also bring some higher costs in the form of higher nominal interest rates as lenders—who expect higher inflation too—build in protection for themselves in their contract rates. But the combination of deductible interest payments, tax-free capital gains and tax-free "implicit" housing income more than offsets the direct effect of the higher finance costs.

The housing rush

Given the stimulus that tax policy provides homeownership in an inflationary era, it is no surprise, then, that something like a "housing rush" developed during the 1970's. The nation produced 17.8 million housing units during the 1970's, a substantial 24-percent increase over the previous decade's production. Although a maturing baby boom also

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caused the number of individuals of home-buying age to grow rapidly during this period, by the end of the decade the number of occupied housing units *per capita* was at an all-time high.

In addition, contrary to the relatively minor role played by "no-frills" housing, the quality—as well as the quantity—of housing was on the rise during the last decade. The average home in 1979 had a greater floor area, more bathrooms and bedrooms, and more amenities (such as garage space and central air conditioning) than a new home in 1970.

All of this is suggestive of a major shift of real resources to the housing sector, a pattern that is reflected, too, in credit flows. During the 1970's, $586 billion flowed into home financing. This represents an increase in the share of mortgages in total flows from an average of 19 percent in the 1960's to a 20.5-percent share in the 1970's. Still, government-sponsored institutions played a major role here, financing almost one-fourth of all home mortgages in the 1970's (see chart).

This picture of an inflation and tax-distorted boom in the housing sector does not square with many people's perspective on the housing market. Housing leaders are more apt to remember the volatility of the industry than its substantial growth, because many fortunes have been lost in the increasingly wide fluctuations affecting the industry. In the 1973-75 downturn, and again in the 1978-80 downturn, housing starts declined by half or more. More fundamentally, many policymakers perceive that a dual crisis is developing in housing: owner-occupied housing is becoming "unaffordable" and the rental market is dwindling. These are very likely surface manifestations, however, of the housing rush described above.

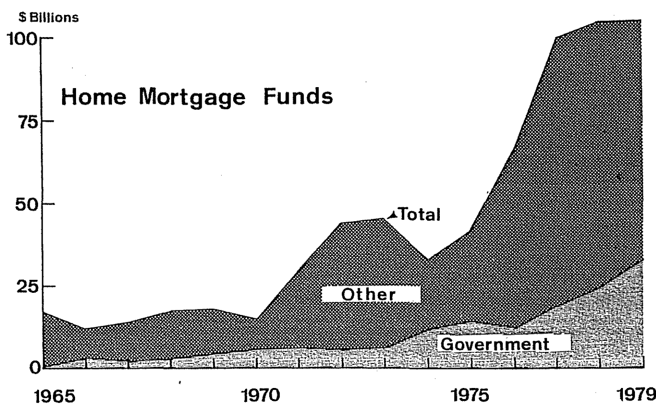
Affordability

There is no doubt that the *purchase price* of housing has risen relative to other prices in recent years. Between 1970 and 1980, the price of a single-family home of a given quality increased at about a 9.3-percent annual rate, as compared with a 6.8-percent annual rise in overall consumer prices (as measured by the deflator for personal-consumption expenditures). In addition, this increase in real housing prices has been accompanied by a sharp rise in mortgage rates.

On the surface, this combination suggests that the costs of homeownership have risen. The true *cost* of housing, however, includes not only interest costs (and maintenance, taxes, and so on) but also the expected capital gains accrual, all after taxes. On this basis, it is not at all clear that the cost of housing has risen. Indeed, the evidence cited above on the increased quantity and quality of housing services being consumed suggests that housing *costs* have probably fallen overall during the 1970's, despite the rise in prices and interest rates.

The convention of a fixed-payment mortgage and a limit on the ratio of mortgage payments to current income, of course, cause some households to experience difficulty qualifying for a loan and taking advantage of these lower costs. This problem—called the "affordability" constraint—is undoubtedly important for many families, particularly during periods of tight money.

Over the last decade, however, this constraint apparently was not very binding. Homeownership appears to have continued to rise, and even first-time buyers (young families) are homeowners in increasing proportions. In 1970, only about 39 percent of households with heads under the age of 30 were owner-occupants; by the middle of the 1970's, that proportion had increased to over 46 percent.



The fact that such trends occurred in the face of mortgage rates and housing prices that were rising faster than income has several explanations. First, banks substantially eased the terms of their loan-qualification tests when they broadened the definition of "income" to include the second income of a household. Secondly, many households had some latitude to "lend to themselves" by contributing more of their savings to housing than they otherwise would. Finally, new mortgage instruments, such as the graduated payment mortgage, may have helped certain borrowers to partially overcome the constraint imposed by high initial mortgage payments.

Rental housing

The performance of the rental market, paradoxically, has been consistent with the notion of a housing rush. Inflation and tax factors—in addition to distorting the position of housing relative to the rest of the economy—have caused distortions *within* the housing industry. Since some of the tax advantages enjoyed by homeowners are not available to landlords (tax-free capital gains, for example), the ability of rental housing to "compete" with owner-occupancy has been somewhat limited. As inflation expectations have risen and made the cost of owner-occupied housing appear low, therefore, the rental market has declined.

This decline has been manifested in several ways. First, the construction of rental property has dropped significantly despite large Federal subsidies. In 1979, total rental-unit construction dropped 20 percent from the preceding year—while the number of unsubsidized starts fell to only half of peak-year volume, and then dropped almost by half again in 1980. Second, many existing multi-unit properties have been converted to condominiums to satisfy homeownership demands. In 1979, about 195,000 units were converted in this fashion, up substantially from earlier years. But a more subtle form of conversion has also occurred with a drop in the proportion of rented single-family homes. Between 1970 and 1976 alone, the proportion of single-family homes occupied by renters dropped from 19.3 percent to 16.6 percent.

Yet these changes must be viewed as a symptom of the overall rush to housing rather than a separate trend. The movement away from rental housing, including the conversion of rental housing to owner-occupancy status, represents a natural consequence of the market's adjustment to the combined impact of inflation and tax regulations.

The future

Any policy moves to channel resources into "reindustrialization" will have to deal with the inflation and tax factors that have distorted the economy's natural patterns of resource allocation during the past decade or so. It will be necessary to bring the tax treatment of housing and other investments into line if the distortions in investment patterns are not to persist. In addition, the relative tax treatment of landlords and owner-occupants may have to be reconsidered to address the issue of imbalances *within* the housing sector.

Housing may, ironically, enjoy benefits from a rationalization of housing and general investment policy. The industry's major problem in recent decades has been the volatility rather than the nominal level of activity. Measures taken to stabilize the relationship between housing and the rest of the economy may thereby reduce the heavy costs of excess capacity in this feast-or-famine industry. Housing is likely to remain a sacred cow, but the beast may actually be healthier with a leaner yet more consistent diet in the decade ahead.

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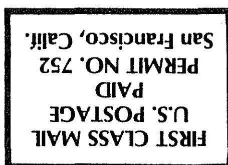

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/12/80	Change from 11/5/80	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	144,133	1,052	8,697	6.4
Loans (gross, adjusted) — total#	122,016	1,034	9,710	8.6
Commercial and industrial	35,736	58	3,818	12.0
Real estate	49,217	100	6,817	16.1
Loans to individuals	23,733	– 8	– 154	– 0.6
Securities loans	1,202	20	– 366	– 23.3
U.S. Treasury securities*	6,687	2	– 777	– 10.4
Other securities*	15,430	16	– 236	– 1.5
Demand deposits — total#	47,193	–1,068	1,141	2.5
Demand deposits — adjusted	35,273	857	2,987	9.3
Savings deposits — total	29,484	– 417	481	1.7
Time deposits — total#	67,103	1,226	9,431	16.4
Individuals, part. & corp.	58,180	1,211	8,897	18.1
(Large negotiable CD's)	26,139	520	4,674	21.8

Weekly Averages of Daily Figures	Week ended 11/12/80	Week ended 11/5/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	n.a.	n.a.	39
Borrowings	95	167	277
Net free reserves (+)/Net borrowed(–)	n.a.	n.a.	– 238

* Excludes trading account securities.
# Includes items not shown separately.

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