House Committee on Financial Services
United States Congress

"Legislative Proposals on GSE Reforms"

Testimony of

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Chairman Frank, Ranking Member Bachus, and members of the Committee. Thank you for the opportunity to speak to you today. My name is Michael Flynn and I am Director of Government Affairs for the Reason Foundation. Reason is a non-profit, non-partisan think tank that, for almost four decades, has researched the consequences of government policy and worked to advance liberty and develop ways the market can be used to improve the quality of life for all Americans.

The legislation before you today is a massive undertaking. Over 300 pages long, it could have a significant impact on America's housing sector, as well as the aspirations of millions of families. At a time when segments of the housing market are showing wear and even vulnerability, I know you do not take the task before you lightly.

My remarks will concentrate on the Affordable Housing Fund that would be established by the legislation. Reason has published several studies on the issue of affordable housing, focusing especially on the housing market in California. As a matter of policy, we have significant concerns about this proposed new federal fund.

With housing prices at record highs in many parts of the country, it is understandable that you would be interested in examining ways to make housing more affordable. In many parts of the country, the unavailability of affordable housing is a serious concern. In California, where Reason is headquartered, the demand for housing outstrips the supply by 500,000 to 1 million units. In many parts of the state, the most commonly used 'index of affordability' is about half that in the nation as a whole. Nationally, about 50 to 60 percent of families earning the median income can afford a home in their community, but in many parts of California, only about 25 to 30 percent can.

Unfortunately, a new federal Affordable Housing Fund will not fix this situation. In the end, we believe it will fail. It will not fail because of a lack of resources, although there will be many who clamor for more funds. If the Fund were doubled or tripled—as many groups will request—it would still fail. It will fail because it doesn't address the fundamental problem: too few housing units are being built to meet the demand.

Simply put, this proposal fails three tests:

1. It ignores the real problem;
2. It creates a veneer of action, which will stymie more substantive efforts for meaningful reform; and,
3. It creates a host of unintended consequences, ranging from distortions in the housing market which may exacerbate the problem to wasting resources on activities that have nothing to do with improving the affordability of housing.

I will discuss these briefly.

In many parts of the country, there is a severe shortage of housing. This, combined with monetary policy that has effectively increased the demand for housing, has dramatically increased the cost of housing in many areas. While in recent years the nation has experienced a burst of homebuilding, new construction has not met the robust demand.

It is not for lack of capital. I do not need to tell the members that unprecedented resources have been devoted to construction over the last decade. These figures are well-known. It is also not due to any inherent economic flaw in the housing market, *per se*. There is nothing in the fundamental economics of housing that would skew building towards any particular segment of the market. Entire industries have sprung up catering to the demands of low and moderate income consumers in virtually every other sector of the economy. Housing would be no different, but for one factor: government policy.

No matter how much money from the federal treasury is devoted to housing, it will ultimately run into the chief architects of housing policy in this country, which are state and local governments.

It is no small irony that while this committee deliberates over measures to increase the stock of affordable housing, governmental bodies elsewhere are meeting to consider new growth limits or boundaries, increased impact fees, more stringent zoning requirements, prevailing wage laws, new environmental regulations, open space requirements, or building standards.

While some of these may seem individually reasonable, taken together, they have a cumulative effect that makes homes less affordable for more and more Americans. Moreover, these, as well as other land use restrictions have exploded over the last decade. Today, it is increasingly expensive, cumbersome, and time consuming to build a single-family dwelling. Researchers from the University of California at Berkeley found that prevailing wage mandates on affordable housing projects alone drive up the cost of construction by anywhere from 9 to 37 percent. Reason Foundation's study of housing price trends in Washington State and Florida found that 20 to 25 percent of the housing price increases in these states could be attributed to their statewide growth management laws. In Florida, the impact was significant enough to reverse trends toward more housing affordability in urban counties.

Growth management and land-use restrictions artificially limit the supply of housing that can be built. These restrictions work in two ways. First, housing units are explicitly limited through large lot zoning, housing permit caps, or urban growth boundaries (or limit lines). Second, regulatory burdens increase the uncertainty of the permitting process and dramatically increase the upfront costs needed to apply for and receive approval. Reason Foundation studies have empirically investigated both these effects. The result of this higher level of regulation is to make building lower and middle-income housing, which already involves very tight profit margins, economically risky and less viable. In light of this, it is no surprise that builders often focus at the upper-end of the market. If you are pressured to build fewer units than you otherwise would, you will focus on higher margin products, to achieve the necessary return on capital.

This causes a ripple effect that is felt all the way down the housing ladder. Middle-income or young professional families who might otherwise move to larger, newer homes are priced out of that market. As a result, they seek out older, smaller homes and push these prices up beyond the means of low-income and blue-collar families.

A 2005 study by the Harvard Institute for Economic Research found that, over the last several decades, there have been a growing number of metro area housing markets in which housing prices have risen substantially higher relative to the costs of physical construction. The authors concluded that these changes do not appear to be the result of a dwindling supply of land; rather, they reflect the increasing difficulty of obtaining local regulatory approval for building new homes, making large-scale development increasingly difficult. This problem has been most acute in coastal regions like the Bay Area, Southern California, Seattle, and Boston, but it is increasingly spreading to interior regions like Austin, Denver, and Raleigh-Durham. In other words, regulation is artificially constraining the supply of housing, so we’re left with higher prices and fewer new homes being built.

It is the total stock of housing that dictates the relative affordability of homes. There is a general misconception that affordable housing is lacking because no one is building it. But, affordable housing is not generally new housing. It is housing that is made available as families move into newer, more expensive housing. Any artificial falloff in new construction creates bottlenecks throughout the system.

Unless we deal with this bottleneck, which again is mostly the result of regulations and restrictions that limit growth and construction, we’re simply applying a band-aid to a gaping chest wound. Special subsidies, loan guarantees, credits, or even blanket changes in the measure of affordability can't alter this equation, as the recent meltdown in the sub-prime market shows.

Now, even the smallest band-aid will stop some bleeding. If the federal government decides to pump billions of dollars into affordable housing initiatives, no doubt some new units will be built. Some number of families will be lucky enough to benefit from this. But, a great opportunity will be lost. We will have lost the opportunity to review the range of regulations and restrictions that impact the housing market. State and local officials, content to see millions of dollars flowing into their community, will never consider the consequences of the restrictions they enact. The fundamental factors that artificially limit the supply of housing will remain in place; the crisis will simply be put off until another day.

Of course, a lot of that money will be wasted. First, there are state and local elected officials, who often treat new money from Washington as a lotto jackpot and view the stipulations for their use as suggestions. It may be redirected to uses only tangential to housing or it may simply replace resources that were being spent, resulting in fewer new resources than would be expected. Or, even if spent as directed, it may exacerbate distortions in the housing market that will further reduce the overall supply of affordable housing. Several Reason studies examining particular programs in California are cited at the end of my testimony.

Housing policy has often created distortions which can be gamed by many of the players. There are of course some developers and landlords who have manipulated the system. In many places, inclusionary zoning restrictions, which mandate that a certain percentage of a development be set-aside for low-income groups, have sparked a cottage industry in the selling and buying of these set-asides. While lucrative for some, they fail to improve the lives of families searching for housing.

Moreover, statistical analyses of these programs by economists at San Jose State University found that cities that adopted inclusionary housing programs experienced dramatic declines in private market housing construction. The number of units created through these programs were minor compared to the measured need in these communities and could not come close to compensating for the lower level of housing construction in these communities. In Los Angeles and Orange Counties, for example, 17,296 fewer homes were produced in the eight cities with inclusionary zoning ordinances while just 770 "affordable" units were produced. Because housing supply was reduced but lower rate housing was subsidized through the private market, the effect of the inclusionary housing ordinances was to increase housing prices by $33,000 to $66,000 per unit.

I would be remiss if I didn't mention one particular organization that has carved itself a lucrative niche from housing programs. The Association of Community Organizations for Reform Now (ACORN) is a multi-national conglomerate that acts as the umbrella for more than 70 organizations. Among these are a number of state housing associations or corporations, as well as the ACORN Housing Corporation, which operates nationally. In the mid-1990s, the ACORN Housing Corporation received a $1.1 million grant from the AmeriCorp program to train AmeriCorp workers to assist low-income families trying to purchase homes. According to evidence uncovered by the program's Inspector General in 1994, these workers were directed to inform these families that they had to become dues-paying ACORN members in order to receive the assistance. Because they effectively were using the grant to increase the membership of ACORN, which engages in political advocacy, AmeriCorp terminated the grant.

This commingling of government grants between affiliated organizations and the ACORN political organization continues. According to tax records, between 1997 and 2003, ACORN Housing Corporation received more than $11 million in government grants. Almost half, over $5 million, was paid out to other ACORN entities as either fees, rent, or grants.

The examples of ACORN's misuse of government grants, especially housing grants, are too many to cover in this single hearing. I would be happy to provide the Committee with other instances, but suffice it to say that it stretches back for 30 years. In almost all cases, the misuse of funds has been tied to political advocacy. The prospect that such an organization – rather than low- and middle-income Americans—could benefit from a new infusion of federal housing resources is troubling.

Even if Congress were able to construct a Housing Fund in such a way that such waste and abuse were eliminated and it were certain that every single dollar went to affordable housing initiatives, it couldn't achieve its intended goal. There isn't a lack of resources to build housing; there is an overabundance of regulation limiting the construction of any housing. This causes a bottleneck that is felt through every segment of the housing market.

Thank you. I would be happy to take any questions you have.

Selected policy studies on affordable housing published by Reason Foundation:

Chris Fiscelli, *New Approaches to Affordable Housing*, April 2005, http://www.reason.org/update20_affordablehousing.pdf

Benjamin Powell and Edward Stringham, *Do Affordable Housing Mandates Work? Evidence From Los Angeles County and Orange County*, June 2004, http://www.reason.org/ps320.pdf

Benjamin Powell and Edward Stringham, *Housing Supply and Affordability: Do Affordable Housing Mandates Work?*, April 2004, http://www.reason.org/ps318.pdf

Geoffrey Segal, William Fulton et al., *Smart Growth in Action II: Case Studies in Housing Development From Ventura County, California*, May 2003, http://www.reason.org/ps311.pdf

Samuel R. Staley and Leonard Gilroy, *Smart Growth and Housing Affordability: Evidence from Statewide Planning Laws*, December 2001, http://www.reason.org/ps287.pdf

William Fulton, Chris Williamson, Kathleen Mallory, and Jeff Jones, Housing Capacity and Development in Ventura County, California, January 2002, http://www.reason.org/ps288.pdf