



THE STATE OF THE  
**NATION'S  
HOUSING**  
2006



Joint Center for Housing Studies of Harvard University

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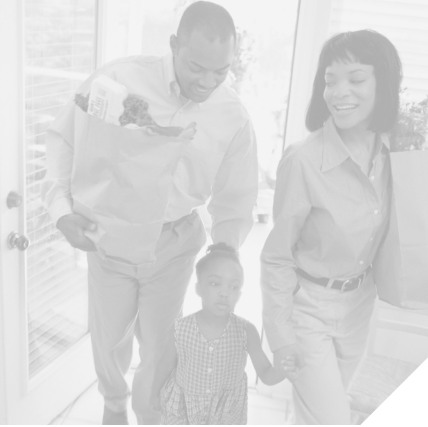
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# EXECUTIVE SUMMARY

The housing boom came under increasing pressure in 2005. With interest rates rising, builders in many states responded to slower sales and larger inventories by scaling back on production. Meanwhile, the surge in energy costs hit household budgets just as higher interest rates started to crimp the spending of homeowners with adjustable mortgages.

Nevertheless, the housing sector continues to benefit from solid job and household growth, recovering rental markets, and strong home price appreciation. As long as these positive forces remain in place, the current slowdown should be moderate.

Over the longer term, household growth is expected to accelerate from about 12.6 million over the past ten years to 14.6 million over the next ten. When combined with projected income gains and a rising tide of wealth, strengthening demand should lift housing production and investment to new highs. But with the economy generating so many low-wage jobs and land use restrictions driving up housing costs, today's widespread affordability problems will also intensify.

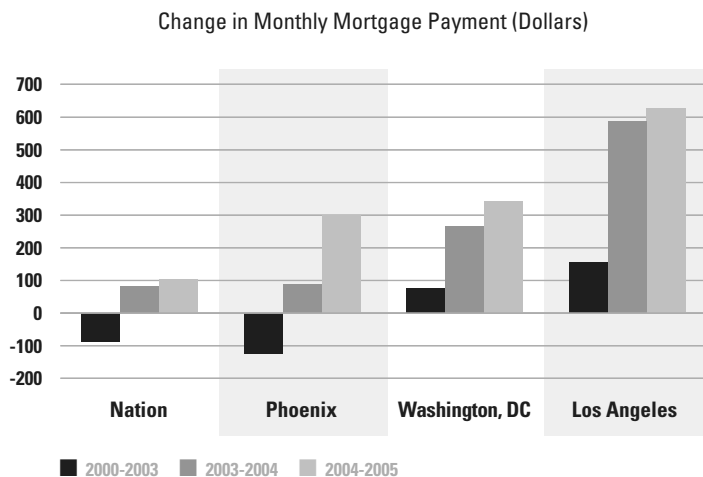
## STRETCHING TO BUY HOMES

Although monthly mortgage costs to buy a median-priced home with a fixed-rate loan have risen only in the past two years, affordability in the nation's hottest housing markets has been eroding for some time (Figure 1). Unlike in metropolitan areas with more moderate appreciation, the interest rate declines in 2000–2003 did not offset the impact of skyrocketing prices in these markets. Affordability pressures are now spreading, with median house prices in a growing number of large metros exceeding median household incomes by a factor of four or more (Table W-2).

Even so, homebuyers scrambled to get in on still-hot markets last year. In stretching to afford ever more expensive homes, borrowers increasingly turned to mortgage products other than fixed-rate loans to lower their monthly payments at least initially. The most popular of these loans was the standard adjustable-rate mortgage, followed by interest-only loans, with payment-option loans a distant third.

In just two years, interest-only loans (which defer principal payments for a set number of years) went from relative obscurity to an estimated 20 percent of the dollar value of all loans and 37 percent of adjustable-rate loans originated in 2005. Payment-option loans, which let borrowers make minimum payments that are even lower than the interest due on the loan and roll

**Figure 1** Affordability Is Eroding Under the Weight Of Rising Interest Rates and House Prices

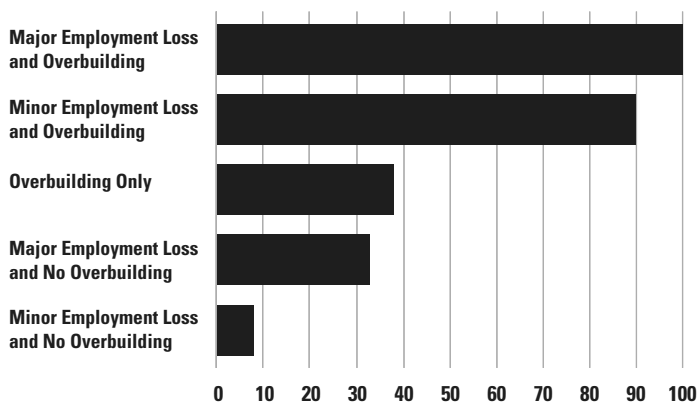


Note: Monthly payments are based on 90% of the median house price, adjusted for inflation by the CPI-UX for All Items.  
Sources: Freddie Mac Conventional Mortgage Home Price Index and Primary Mortgage Market Survey; National Association of Realtors®, Metropolitan Area Existing Single-Family Home Prices.

Figure 2

## While Overbuilding and Job Losses Often Lead to Large House Price Declines...

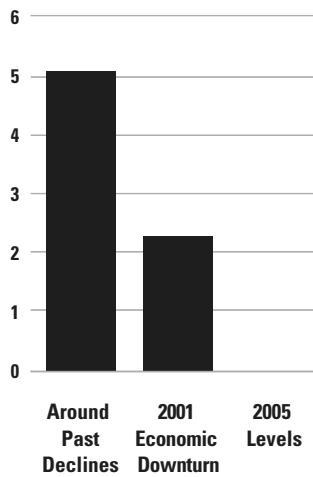
Percent of Times That Conditions Led to a Price Decline of 5% or More, 1975-1999



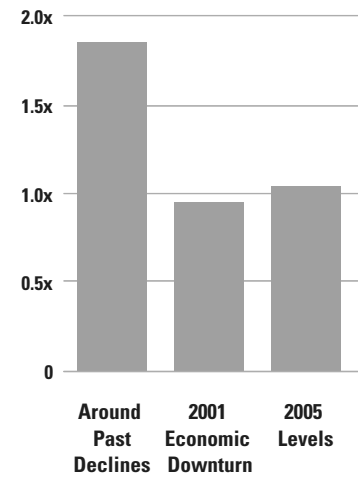
Notes: Includes the 75 largest metros based on 2000 population. Major (minor) employment loss is defined as periods of net decreases of at least 5% (under 5%). Overbuilding is defined as periods when one- to three-year average annual permitting levels per 1,000 residents were at least double the 1980–2004 median annual level for that metro. Sources: Freddie Mac Conventional Mortgage Home Price Index; Census Bureau, Construction Statistics; Bureau of Labor Statistics.

## ...Neither of These Preconditions Exists Today

Average Employment Loss (Percent)



Average Ratio of Prior 3 Years to Long-Run Permit Intensity



Notes: Includes 75 largest metropolitan areas with past major price declines that also lost jobs in 2000-3. Long-run permit intensity is the median number of permits per 1,000 residents for that metro from 1980 to 2004. Sources: Census Bureau, Construction Statistics; Bureau of Labor Statistics.

the balance into the amount owed, accounted for nearly 10 percent of last year's loan originations, but a much smaller share of outstanding loans. While these products helped to shore up housing markets last year by blunting the impacts of rising interest rates and home prices, proposed federal guidelines may limit their use in the future.

Although borrowers with interest-only loans will see their housing outlays jump when their principal payments come due, these increases are still several years off. Borrowers thus have time for their incomes to catch up, for interest rates to fall, or to either refinance or move.

Fortunately, most homeowners have sizable equity stakes to protect them from selling at a loss even if they find themselves unable to make their mortgage payments. As measured in 2004—before the latest house price surge—only three percent of owners had equity of less than five percent, and fully 87 percent had a cushion of at least 20 percent.

### HOUSE PRICE RISKS

The greatest threat to housing markets is a precipitous drop in house prices. Fortunately, sharp price declines of five percent or more seldom occur in the absence of severe overbuilding, dramatic employment losses, or a combination of the two (Figure 2). The fact that these conditions did not exist and that interest

rates were so low explains why the housing boom was able to continue without interruption when the recession hit in 2001.

With building levels still in check and the economy expanding, large house price declines appear unlikely for now. But if the economy falters, both job growth and housing prices will come under renewed pressure. This would spark higher default rates, especially among subprime borrowers, and turn housing from an engine of economic growth to a drag.

### STRONG DEMAND FUNDAMENTALS

Despite the current cool-down, the long-term outlook for housing is bright. New Joint Center for Housing Studies projections—reflecting more realistic, although arguably still conservative, estimates about future immigration—put household growth in the next decade fully 2.0 million above the 12.6 million of the past decade (Figure 3). On the strength of this growth alone, housing production should set new records.

With each generation exceeding the income and wealth of its predecessor, growth in expenditures on home building and remodeling should match if not surpass the current pace. For example, the median inflation-adjusted income of households in their 40s was \$1,800 higher in 2005 than in 1995, while that of households in their 50s was \$1,900 higher. Similarly, between 1995 and 2004, the median wealth of those in their

40s was up by \$33,600 and of those in their 50s by \$46,600. But incomes at the top are increasing much faster than those at the bottom and in the middle. These differences will likely drive rapid growth in the burgeoning luxury sector of the housing market, but present stubborn affordability challenges for households with low and moderate incomes.

As members of the baby-boom generation reach their 50s and 60s with record wealth, they will boost the market for senior

housing and second homes. At the other end of the age spectrum, the baby boomers' children, together with same-age immigrants and second-generation Americans, will buoy demand for starter homes and apartments. As this large generation moves into adulthood, demographic forces will favor rental over for-sale housing.

Meanwhile, foreign-born and minority households will continue to be the fastest-growing segments of the housing market. Thanks to strong immigration and slightly higher rates of natural increase, the minority share of households should expand from 28 percent in 2005 to over 32 percent in 2015.

Foreign-born individuals already represent 13 percent of the US population, including 18 percent of young adults aged 20 to 29. Immigrants have added especially to the ranks of the baby-bust and echo baby-boom generations, bringing new life to center cities that once experienced population declines. Immigrants thus represent not only a key source of labor for the housing industry, but also a large and growing customer base.

### LONG-TERM HOUSING CHALLENGES

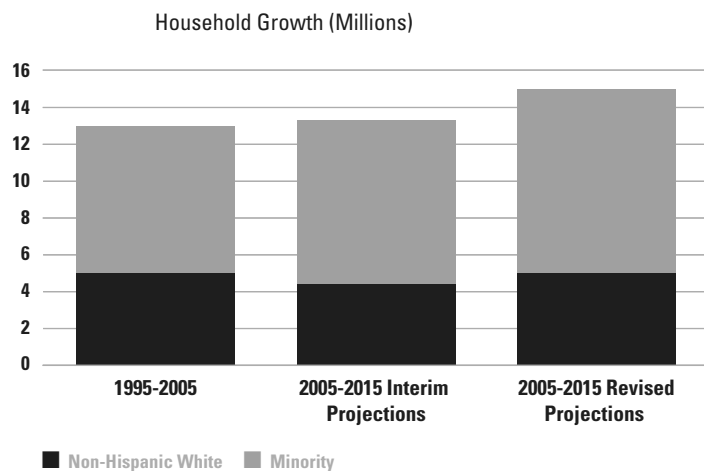
While the vast majority of Americans still pay a manageable share of their income for housing, affordability problems are worsening. In just the three years from 2001 to 2004, the number of households paying more than half of their incomes for housing shot up by 1.9 million. This increase brought the total number of low- and middle-income households with severe cost burdens to 15.6 million.

Working in no way protects families from the hardship of high housing outlays. In fact, 49 percent of poor working families with children (working more than half time but earning less than the poverty level) had severe cost burdens in 2004 and 75 percent had at least moderate burdens. Among near-poor working families with children (with incomes one to two times the poverty level), the share with severe burdens was 17 percent and with at least moderate burdens 52 percent.

As households spend excessive shares of their incomes on housing, they have little left over for other basic needs (Figure 4). Accordingly, many choose to trade off longer commutes for more affordable housing. As evidence, households in every expenditure quartile with low housing outlays spent much more on transportation than those with high housing outlays. Among those in the bottom expenditure quartile, for example, the difference in travel costs between the two groups was \$99 per month.

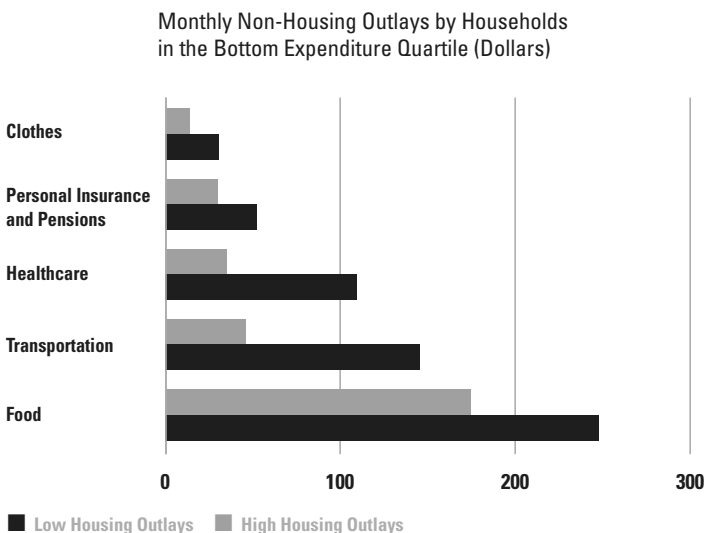
Meanwhile, Hurricane Katrina exposed the longstanding problem of concentrated poverty. Despite some progress at the national level, about one-tenth of the nation's poor still live

**Figure 3 Household Growth in the Next Decade Should Be Even Greater Than in the Last**



Sources: Census Bureau, Housing Vacancy Survey; George Masnick and Eric Belsky, "Revised Interim Joint Center Household Projections Based Upon 1.2 Million Annual Net Immigrants," JCHS Research Note N06-1, March 2006.

**Figure 4 Households with Excessive Housing Outlays Have Little Left Over for Other Necessities**

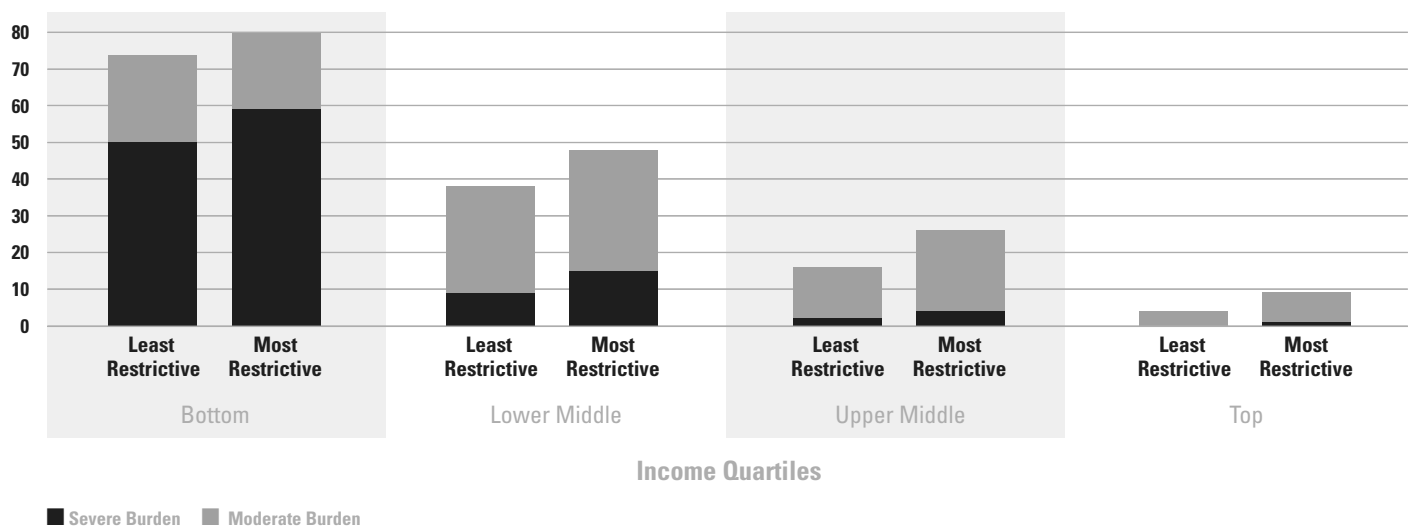


Notes: Expenditure quartiles are equal fourths of all households by average monthly spending. High (low) housing outlays are defined as more than 50% (less than 30%) of total monthly expenditures. Source: JCHS tabulations of the 2003 Consumer Expenditure Survey.

Figure 5

## Tougher Development Regulations Push Housing Affordability Problems Higher up the Income Scale

Share of Cost-Burdened Households in Metro Areas with More or Less Restrictive Regulations (Percent)



Notes: Least (most) restrictive metros rank in the bottom (top) third of regulatory constraints. Moderate (severe) burdens are housing costs of 30-50% (over 50%) of household income.

Sources: R. Saks, "Job Creation and Housing Construction: Constraints on Employment Growth in Metropolitan Areas," JCHS Working Paper W04-10, December 2004; JCHS tabulations of the 2003 American Community Survey.

in neighborhoods with poverty rates over 40 percent. While the number of high-poverty areas has fallen in most metros, the problem nonetheless persists in nearly all metropolitan areas and in fact intensified in 70 metros during the 1990s. Indeed, even in neighborhoods that dipped below the high-poverty threshold of 40 percent, the median poverty rate was still a substantial 31 percent.

### GOVERNMENT'S ROLE

With so many Americans struggling to afford housing, the federal government has stepped up by providing subsidies to about one-quarter of renter households with incomes of less than half of area medians. These subsidies typically hold tenant rent contributions to 30 percent of household income. In addition, states are authorized to issue tax-exempt bonds and housing tax credits, which have financed nearly two million low-income rental units, as well as assisted more than two million first-time homebuyers over the past 15 years. State and local governments also allocate federal block grants, along with housing trust funds, to assist in creating affordable housing and broadening opportunities for low-income homeownership.

At the local level, however, land use regulations often make it difficult for builders to develop affordable housing. Large minimum lot sizes, restrictions on the land available for residential development, impact fees that place the marginal cost of infrastructure and public services on new homebuyers, and approval processes that add risk and delays all play a hand in rising house prices.

Because per-unit impact fees and permitting costs represent such a large share of the costs of developing modest units, they directly discourage the production of low-income housing.

While many land-use regulations address important public policy concerns such as environmental protection and public health, they nevertheless make housing more expensive. Indeed, the stricter the development regulations, the more intense the affordability problems in that community (Figure 5).

But relaxing land use regulations alone will not eliminate the nation's housing affordability problems. The costs of owning and operating even modest housing far exceed the rents that many low-income households can afford to pay without deep subsidy. As a result, affordable rental housing is disappearing at an alarming rate. Between 1993 and 2003, the supply of rental units affordable to those earning \$16,000 or less shrank by 13 percent. These dramatic losses increased the shortfall in units available to these low-income households to 5.4 million.

Federal efforts to address this challenge have been critical but insufficient to keep up with the growing demand. Making significant headway will be difficult without the combined efforts of all levels of government to expand housing subsidies, create incentives for the private sector to build affordable housing, institute land use policies that reduce the barriers to development, and educate the public about the importance of affordable housing. ■