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## **Remarks by Governor Edward M. Gramlich**

**At a meeting on rental housing hosted by the John D. and Catherine T. MacArthur Foundation, Washington, D.C.**

**November 14, 2003**

For many years the MacArthur Foundation has been a mainstay in the effort to expand the supply of affordable rental housing in the United States. This luncheon brings together more than thirty organizations involved in a new \$50 million Foundation initiative aimed at preserving and improving affordable rental housing. You are pursuing a very worthwhile objective, and I am delighted to participate in your meeting.

When Americans think of housing, they usually think of homeownership. Spending on largely owner-occupied, single-family units has increased smartly in recent years, and has been one of the factors preventing the economic slowdown from being worse than it has been. This spending has been supported in no small way by a revolution in mortgage credit markets, extending subprime credit much further down the income scale. The extension has not been free of problems--the Federal Reserve now spends much time and effort studying and determining what to do about predatory lending--but by and large the extension has enabled millions of new homeowners to have a chance at the American dream of owning a home and building wealth. As if to emphasize the point, the Commerce Department recently reported that the American homeownership rate has reached an all-time high of 68.4 percent, a rise of 5 percentage points in the past decade. For what it is worth, this rise places the United States just behind Spain, Finland, Ireland, and Australia in international homeownership rates, roughly on a par with the United Kingdom, and well above the rate in most other industrial countries.

The fact that seven out of ten American households now live in their own homes is reassuring; but seven out of ten is not ten out of ten. Millions of Americans still rely on rental housing. Although at any one point in time only three of ten Americans are living in rental housing, over the life cycle that number is more like ten out of ten--virtually all household families live in rental housing for at least some period in their life. They may start with rental housing after getting out of school and end there after selling the family residence. Even at the top of the income scale rental housing is important. The Federal Reserve's Survey of Consumer Finances indicates that nearly one-tenth of the top quintile of earners are renters. Rental housing is indispensable for households in transition between locations, for workers on temporary assignment, for immigrants, and especially for low-income people. Unfortunately, some of these low-income people may never get to the point where they can afford a home, and must rely on rental housing throughout their lifetime. For these reasons, for high- and low-income households alike, it is impossible to imagine a well-functioning housing sector without an ample supply of rental housing.

The aggregate statistics on rental housing do not indicate anything particularly alarming, but below the surface there are clear trouble spots. Overall rental vacancy rates have risen in recent years and are now near record highs for apartments with two or more occupants and

clearly at record highs for single-family rental units. With the rise in vacancy rates one would expect a moderation in price pressures, but in fact rental rates have increased in real terms as well. Much speculation exists about why this is the case, but one factor clearly seems to involve an internal shift--new multifamily units are substantially more expensive than the units being lost. This trend, caused by escalating development costs, conversion of previously subsidized properties, and local resistance to multifamily construction, is resulting in a change in composition of available rental housing which works to the detriment of lower-income renters.

Most of the social problems involving rental housing pertain to what I will call the lower-income sector, specifically rental units available to low- and moderate-income households. According to official statistics, this "affordability" sector comprises roughly half of the nation's thirty-four million rental units. For this sector of the market, the supply conversion issue is aggravated by several trends on the demand side. After a brief respite, income disparities are growing again, resulting in smaller income gains in the lower-income parts of the distribution than among those with high incomes. There has also been some rise in unemployment, and a steady rise in the number of immigrants. Although we are still a few years away from the retirement of the baby boomers, numbers of aged renters will soon begin to rise and stay high for several decades. All factors together will put price pressure on the dwindling supply of affordable rental units.

Statistics on the lower-income part of the rental market, many of which you are familiar with, confirm these fears. The Joint Center for Housing Studies reports that nearly seventeen million renter households in the United States have housing-related problems. Roughly seven million have severe cost burdens, spending more than 50 percent of their income on housing; another seven million have moderate burdens, spending 30 percent to 50 percent of their income on housing. About 2.5 million renter households have multiple problems--severe or moderate cost burdens, overcrowding, or living in seriously inadequate units. Many of the families with severe cost burdens are working close to full time, indicating that having a job is not enough to ward off affordability concerns. Not surprisingly, the incidence of housing difficulties is disproportionately high among very low-income households, African-American and Hispanic families, and female-headed families with children. Geographically, families with housing needs are not confined to cities but are spread across suburban and rural areas as well.

The physical quality of the available affordable rental housing stock represents another problem. Whereas in the 1980s about half the available stock was more than twenty-five years old, now that ratio is more like two-thirds. The Joint Center estimates that more than a million renter households live in housing that is considered seriously inadequate, and more than 2.5 million live in rental housing considered moderately inadequate.

The overall social implications of this shortage could be quite serious. Households spending more than half their income on housing, by definition, have very little income left to spend on anything else--food, child-care, education, health care, and so forth. Households that cannot afford decent housing are likely to be forced to live many miles from their jobs, or from any jobs, and to have to spend a great deal of time and money commuting to work. Households living in cramped or inadequate quarters are vulnerable to higher crime rates and other social problems, such as below-average public schools. There are any number of ways in which housing shortages can lead to serious social problems for the affected households, now and for their long-term prospects, and to a shortfall in overall economic

performance for the economy.

This all leads to some difficult policy questions. Numbers of households that depend on lower-income rental housing are rising, low incomes are roughly stagnant, the new supply of affordable units for lower-income families is stagnant, many units are being converted from lower-income to high-income housing, the existing stock is aging, and millions of households are either paying a high share of their income for housing, living in substandard housing, or both. What to do?

A first question involves incomes. I am at the Federal Reserve, and it would be nice if the Fed could wave a magic wand and raise incomes. To be sure, the Fed controls an important policy instrument, monetary policy, but the Fed doesn't have a magic wand. The best that the Fed can do is to stabilize prices and stabilize income growth around its long-term trend, thereby preventing large increases in unemployment. Both types of stability might, to some degree, improve long-term growth prospects for the American economy. But even under these circumstances, Fed policy must be motivated by overall macroeconomic conditions. There is no way the Fed can go beyond its overriding stabilization concerns to try to improve the income conditions of particular groups.

By cutting taxes on lower-income households and raising them on higher-income households, tax policy could put more spending power in the hands of low-income households. But given the flavor of recent tax policy debates, it is hard to forecast such a change. In recent years, the idea of using tax policy to redistribute income in favor of low-income groups seems to be about as popular as the idea of raising taxes.

As for spending, the Section 8 voucher program provides rent vouchers to residents with income that is less than half of the area median to help pay the rent in privately-held apartments. By the mid-1990s more than a million households had received this form of assistance. The program seems to have worked well, though many of the rent voucher payments are small, and even a million households is a small number relative to the size of the number of rental housing gaps described earlier. Although added Section 8 assistance would be welcomed, it would take an enormous amount to cure these rental housing problems on the demand side of the market.

On the supply side, the obvious possibility would be to increase the new construction of rental units available to lower-income households. This construction was in fact subsidized by the various tax shelters available in the early 1980s, mostly eliminated in the Tax Reform Act of 1986. The Low Income Housing Tax Credit (LIHTC) was introduced then to cushion the effect of base-broadening tax reform on the supply of low-income housing, and this LIHTC now stands as the single most important federal supply program. The LIHTC offers private investors, who provide the equity needed to build or rehabilitate qualified housing, a ten-year sellable tax subsidy. In exchange for the tax subsidy, owners are required to maintain, for fifteen years, units affordable to households that make less than 60 percent of the area median. The program has been modified over the years, among other things to extend the fifteen year affordability period. Since 1987 more than a million apartment units have been constructed under the program, adding about 25 percent to new multifamily construction annually, and costing slightly more than \$3 billion a year. Even if the program continues in much the present form, in any particular year there will be a significant number of units for which the affordability restriction will expire, leading to the phenomenon of running harder to stay in the same place.

Beyond the LIHTC, one could, of course, imagine further tax subsidies for new construction and/or rehabilitation. But there is a significant problem with all of these incentives--where does the money come from? The budget situation at all levels--federal, state, and local--is a mess and is likely to remain so until spending is cut or taxes are raised. Indeed, budgets are now so far out of balance that even stiff fiscal austerity packages are unlikely to stem the tide of red ink. This tight budgetary situation also has indirect effects. Much past housing support has come through nonprofit institutions, but many of these are struggling as well, restricted by declining state and local support on one side and lower endowment payouts on the other.

This is the challenging atmosphere facing the MacArthur Foundation and other groups supporting affordable rental housing. The demand-supply imbalance is tight now and likely to get tighter. Chances of raising the incomes of lower-income renters are limited, beyond the macroeconomic and budget policy measures that have already been taken. It is difficult to expand the supply of affordable rental housing, beyond the measures that have already been taken. The fiscal picture is dismal.

When all else fails, one can always try ingenuity, and there does seem to be plenty of that in the affordable housing area. I chair the board of the Neighborhood Reinvestment Corporation (NRC), a quasi-governmental housing program just now celebrating its twenty-fifth anniversary. The program gets a federal subsidy of about \$100 million a year, passing much of it along to its 226 local affiliates. Ultimately this \$100 million generates about \$1.7 billion of annual housing assistance, a leverage ratio of 17. Although the NRC focuses on homeownership, it by no means ignores rental housing. The NRC provides annual assistance to families in more than 40,000 rental structures around the country, more than doubling the number just a year ago. The MacArthur Foundation knows all about this program because it provides \$2 million to the NRC's new loan fund, helping finance the preservation of rental properties, along with providing added direct support to many of the NRC's multifamily lenders. I have visited several of the rental units sponsored by the NRC, and they do indeed seem to contain lively, vibrant communities living in very liveable structures. On the other hand, as with the above programs, it would take an enormous expansion to make a substantial dent in the existing demand-supply imbalance.

In this regard, there is an interesting recent book by Alexander von Hoffman, *House by House: Block by Block*. Old timers like me remember back in the 1960s when Alexander's father, Nicholas, was writing radical columns for the Washington Post. His repeated theme was basically that most of society's institutions were either corrupt or ineffective. A generation later his son, Alexander, is arguing that housing conditions are actually improving in New York, Boston, Chicago, Atlanta, and Los Angeles, partly for home ownership but also in the rental sector. Frankly, the book confirms my own impression from the NRC field trips that there are many effective programs out there, employing many different approaches to improving housing. These impressions, either mine or von Hoffman's, are anecdotal. We see the successful programs but probably do not see the unsuccessful programs or the dreary neighborhoods that never get better; but at least there are many successful programs.

With that background, I might raise a few questions from the literature on affordable rental housing, comparing it to my impressions from field trips and elsewhere.

- *Macro versus micro*. One examining the macro literature on overall imbalances finds

these imbalances in the millions. According to the Joint Center, more than 2 million new affordable rental units are needed to balance demand to supply--a significant gap. On the other hand, field trips leave the impression described above that things may be going pretty well. What is the cause of the disjoint? Maybe our macro figures are inconclusive, maybe our anecdotal impressions are biased, or unrepresentative, maybe field trips just do not cover all the areas that need help. Whatever the case, at some point we will need better quantitative indicators of rental housing problems.

- *Subsidy issues.* Today low-income rental housing is subsidized on the demand side by Section 8 vouchers and on the supply side by the LIHTC and older project-related subsidies. It would be nice to imagine a world without any required subsidies, but that dream probably is impractical. The more scarcity pushes up rental rates, the less affordable rental housing gets, and the more at least some lower-income households are likely to need a subsidy.

But a host of subsidy-related questions remain. The primary one, of course, is the extent to which the social externalities of inadequate housing justify housing subsidies. I presume that most people in the room think they do, but we can always use better analytical evidence.

Beyond that, in neoclassical economics the subsidy required to stimulate a certain amount of housing is the same if given on the demand or supply side of the market. But that may not be the case in the real world. If not, is it more efficient to subsidize on the demand or supply side of the market? How large should subsidies be? Should subsidies focus on particular households or units, or be generally available across the market? There are a number of such evaluative questions, and it would certainly be refreshing to see these subsidy policies handled in an analytical manner.

- *Construction versus preservation.* Most of those in the field, including the MacArthur Foundation, have looked at supply incentives on the one hand and massive needs on the other, and conclude that a strong preservation focus is critical. There is an obvious rationale for such a focus. First, preservation uses the existing housing stock and is likely to be much cheaper than new construction. Moreover, it is painful to imagine the remaining green spaces around major cities being converted to endless housing projects. Surely we can make better use of the existing structures, many of them constructed when structures were constructed in a sturdy manner. The transportation infrastructure is already there, the social infrastructure may be there as well, and we should use it.

At the same time, it is hard to imagine an ample supply of low-income rental housing without at least some net new additions to the rental housing stock. If there are new additions, they must be sited properly. To the extent possible, it would be nice to see these units located near either jobs or transportation facilities, so occupants can get to places of employment, and developed in a way that does not perpetuate income and social disparities.

- *Mixed-income versus low-income.* In the 1950s there were construction subsidies for massive public housing projects for low-income families. These may have been maximally efficient from the standpoint of creating the most housing per dollar, but that was it. The experience with public housing of this sort was depressing indeed,

and by now many of these structures have been blown up, with very few tears shed.

We now have a chance to start over, with mixed-income public housing. There is a tradeoff here, in the sense that there will not be as many affordable units per dollar, or per square foot of urban space, in mixed-income developments. But the mixed-income housing will address other social objectives. We care not only about putting people in liveable houses, but also in giving them a liveable atmosphere and in building healthy neighborhoods. Mixed-income housing projects at least have the potential to permit the low-income housing renters to mix with other groups, to learn from them, integrate with them, and have their children share schools. Of course no one can predict the degree to which these laudable goals will be promoted by mixed-income housing, but we do know that these goals were not fulfilled earlier with rental housing populated solely by low-income households.

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There is no shortage of questions to be asked about rental housing, and I could go on. More than likely, further discussion would expose further trouble spots, further rationales for support, and maybe even further evidence of progress. Whatever the case, significant challenges are ahead in the struggle for an adequate supply of rental housing overall and an increased supply of affordable rental housing. The MacArthur and other initiatives will need all of the experience and knowledge you have learned over the years, and more. I wish you well.

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**Last update: November 14, 2003**