1

Chasing the American Dream

Home Sweet Home. There's no place like Home. Home is where the heart is. Home is where you hang your hat. A man's Home is his castle. A house is not a Home. Mi casa es su casa. Few things have captivated the heart, mind, and soul of the American public as much as the concept of homeownership. Living in the home you own is viewed as a basic American privilege and a core component of the American cultural norm of what it means to be a success.

The vast majority of Americans, whether renters or homeowners, have long believed that owning a home is a better financial strategy than renting a home is. Indeed, homeowners and renters of all races and income groups continue to believe that owning a home is the safest long-term investment they can make. Americans continue to hold on to this belief, even though millions of Americans have low (or no) savings, stagnant (or declining) income, and unstable (or no) employment. Indeed, not even the worst economic slowdown since the Great Depression, skyrocketing foreclosure rates, and plummeting home prices could convince most Americans that becoming a homeowner is not low-cost, low-risk, or easily attainable. For example, more than two-thirds of the people polled in a 2010 Fannie Mae survey felt that homeownership is preferable to renting because homeownership gives you more space for your family, more control over your living space, and is a better investment than renting.[1]

While U.S. housing policies have focused on increasing homeownership rates since President John Quincy Adams extolled the concept of sea-to-shining-sea continentalism, the U.S. government did not make homeownership the centerpiece of U.S. housing policies until Franklin D. Roosevelt's New Deal programs in the 1930s. Since then, U.S. political leaders have gone to great lengths to convince Americans that homeownership is low-risk,

[1] Fannie Mae National Housing Survey (2010–2011).

low-cost, and a guaranteed way to increase their household wealth. Sadly, these premises are no longer true for lower- and middle-income Americans. And they have *never* really been true for some Americans.

FINANCIAL BENEFITS

Since the Depression, U.S. housing policies have focused on giving Americans incentives to buy houses and finding ways to increase and maintain high homeownership rates. U.S. housing policies are premised on the assumption that homeownership makes Americans more financially stable, that owning a house provides economic security for homeowners and their families, and that homeowners are more responsible, concerned, and involved citizens than renters are. Deciding to buy your own home is said to instill good financial habits in the potential owner, and becoming a homeowner is said to almost magically transform renters into thrifty, financially responsible individuals. Although no longer true, historically these premises were borne out in reality.

During the recent housing boom, lenders allowed renters to qualify for a mortgage loan and buy a house even if they put little (or no) money down. Historically, however, homeownership served as a forced savings device because everyone who wanted to become a homeowner had to have at least *some* financial capital because they needed money for a down payment or they would never qualify for a mortgage loan. During the first few decades of the twentieth century, a buyer needed to make a down payment of almost 50 percent of the home sales price before a lender would approve his mortgage loan application. After the United States intervened in the housing finance markets in the 1930s to stem the tide of foreclosures triggered by the Depression, a potential home buyer could make a smaller down payment, usually 20 percent of the home price. Even though U.S. housing policies made it easier for some borrowers to buy a house with a low-cost, self-amortizing, government-insured private mortgage, borrowers were still forced to exercise financial restraint and save enough for the down payment. Until lenders all but abandoned their traditional underwriting standards in the recent housing boom, renters who failed to save enough money to make a 20 percent down payment could not buy a home with a long-term, government-insured, prime interest rate loan unless they purchased expensive private mortgage insurance (PMI).

For most of the twentieth century, homeownership served as a forced savings device even *after* borrowers saved enough money to make a down payment and pay their loan closing costs, because the terms and structure of government-insured, fixed-interest rate mortgage loans forced homeowners to be financially responsible. Government-insured, prime interest rate mortgage loans have fixed-interest rates, relatively long repayment periods (typically fifteen or thirty years), and are self-amortizing. Because homeowners had to save enough money each month to make a full payment of principal plus interest for an extended period of time, they were forced to either exercise long-term fiscal restraint or risk losing their homes and the investment they made in those homes.

Buying a home did more than just instill the financial virtues of thrift and saving in homeowners. Homes have historically been sound, stable, long-term investments, and being a homeowner has been a relatively safe way for many Americans to increase their net worth. Overall housing prices during the late 1990s and early 2000s housing boom increased by more than 50 percent, and housing prices in some regions increased annually by more than 10 percent.[2] For a while, homeownership seemed like an almost guaranteed way to increase household net worth, and some homeowners seemed to conclude that homeownership was a low-cost, risk-free way for them to increase their net worth *and* increase their spending.

Skyrocketing housing prices during the recent housing boom made homeowners "feel" rich, and many responded to this feeling of wealth with incessant buying. Overall U.S. consumer debt levels skyrocketed during the housing boom, and some homeowners appeared to believe that no matter how much they increased their spending, they could always dig themselves out of debt with their platinum shovel: the equity in their ever-appreciating Home Sweet Home. Of course, they (wrongly) assumed that housing prices would always rise, interest rates would never rise, home equity loans would always be available, and there (always) would be an available buyer for their homes. While homeowners were feeling house-rich during the housing bubble, renters panicked and feared that they were throwing away their hard-earned dollars by paying rent to their landlords and squandering valuable tax benefits by not owning a home. Watching everybody else buy expensive homes and still spend, spend, spend thanks to the platinum shovel made renters even more determined to become homeowners.

The government uses tax incentives to encourage renters to buy homes. Indeed, one of the largest and most expensive tax expenditures in the U.S. Tax Code is the mortgage interest deduction. People who itemize their tax deductions (instead of taking the standard deduction) can reduce their tax burden by deducting the interest they pay on mortgage loans (including home equity loans and lines of credit) on their primary and secondary homes up to

[2] S&P/Case-Shiller, *National Composite Index of Home Prices*, *available at* http://us.spindices.com/indices/real-estate/sp-case-shiller-us-national-home-price-index.

a certain dollar amount. Itemizers can also deduct the state and local real property taxes they pay for their homes and, if they sell their home and buy a more expensive one, they can shield some of the profits from the sale from federal income taxes. While these homeownership benefits are used only by the small percentage of high-income homeowners who itemize their deductions, *all* homeowners receive an implicit tax break. That is, each month homeowners make a mortgage payment, they are paying themselves the equivalent of rent. Unlike landlords, however, owner-occupants are not taxed on this imputed income, and this untaxed income has recently accounted for more than 8 percent of the U.S. gross domestic product.[3]

HOMEOWNERSHIP HAS ITS PRIVILEGES

In addition to valuable financial benefits, there are powerful social benefits, privileges, and legal rights associated with homeownership, and property owners have always had a higher social and political status than renters. A homeowner makes a financial investment when he buys and then maintains (or improves) his home and his decision to buy the house indicates his intent to be a long-term resident in his neighborhood. Because of this investment and commitment, the homeowner is viewed as having a greater stake in his community than a renter does. To reward homeowners for their commitment to their communities, U.S. housing policies give homeowners the right to control or influence how land near them will be used and who should be allowed to live in their neighborhoods. For decades, both public (i.e., zoning and subdivision laws and policies) and private (i.e., restrictive property covenants) land use laws have allowed homeowners to exclude property uses and people from their neighborhoods. Local land use policies and regulations give homeowners the ability to essentially veto requests for zoning changes in their neighborhoods and fence out activities if they deem the proposed uses to be undesirable, or if they think the activities might be dangerous or pose threats to their neighborhoods.

Homeowners aggressively protect their Not In My Backyard (NIMBY) rights, and their stakeholder mentality makes them think that their views are superior to the views of renters or nonresidents and should prevail in any public policy decision involving how properties in their neighborhoods should

[3] J. Comm. Tax'n., *Present Law and Background Relating to Tax Treatment of Household Debt* (Jul. 11, 2011); Jordan Rappaport, *The Effectiveness of Homeownership in Building Wealth*, Federal Reserve Bank of Kansas City Economic Review (2010), *available at* https://www.kansascityfed.org/publicat/econrev/pdf/10q4Rappaport.pdf.

be used or developed. Thus, whenever a local or state governing authority attempts to place a public project homeowners find undesirable (like a hazardous waste facility, junkyard, halfway house, or homeless shelter) in their neighborhoods, homeowners frequently organize and lobby to try to keep the project out. Likewise, if another property owner seeks to use his property in a way that is not authorized by existing zoning rules, homeowners often band together and object to the request for a variance if the homeowners find the proposed use objectionable.

For almost a century, exclusionary zoning laws have permitted homeowners to fence out more than just undesirable commercial uses. Generally speaking, exclusionary zoning laws protect homeowners from "undesirable" housing (and neighbors) by fencing out structures, including homes that might pose dangers or cause the value of homes to fall. These laws fence out multifamily or other affordable housing based on the view that this type of housing will lower the value of single-family homes or destroy the stability and social order of the neighborhood. Exclusionary zoning laws fence out affordable housing (and, thus, lower- and moderate-income residents) by, for example, requiring builders to construct large homes on large lots. These laws are consistent with the general rhetoric surrounding the American Dream of owning a home. Together with housing policies that allow homeowners to control how their neighborhoods develop, exclusionary zoning laws have helped emboldened homeowners and convinced many that they have the right to live in the "right" neighborhood with the "right" sorts of people.[4]

Of course, allowing homeowners to protect their property interests by excluding certain property uses is not necessarily a bad thing, and *no one* wants undesirable projects to be located near them. But whereas no one wants to live near these projects, *everyone* understands that most of these projects are societal necessities. All homeowners ostensibly have these stakeholder control rights, but only *some* homeowners have been able to use their stakeholder powers effectively and consistently to fence out public, societally beneficial projects or affordable housing. Higher-income homeowners have been much more successful at excluding property uses and residents they deem undesirable. Successful lobbying efforts by higher-income homeowners usually result in them protecting their property values from any potential harm that might

[4] Indeed, merely saying the names of certain cities or neighborhoods triggers a vision of the type of person most likely to live there. Examples of racially or economically branded areas include Harlem, Key West, Detroit, Chevy Chase, Westchester County, Aspen, Martha's Vineyard, South Beach, Beverly Hills, and the like, even if those areas might have transitioning populations. See Sam Roberts, *New York City Losing Blacks, Census Shows*, N.Y. Times (Apr. 3, 2006), at A1.

ensue from being located near societally beneficial but undesirable public projects. But these public projects must be sited somewhere. So, while excluding these undesirable uses from their high-income and predominately white neighborhoods helps these politically strong homeowners, their effective lobbying efforts impose costs on the neighborhoods that are forced to house these projects or housing developments.

The neighborhoods that are most often forced to accept these projects are, not surprisingly, lower-income ones. And, like the residents most likely to be fenced out of the higher-income neighborhoods, the homeowners or neighbors who are often forced to live near these undesirable, albeit useful, projects are often black or Latino. As explained in more detail in later chapters, letting higher-income homeowners fence out property uses (and certain types of people) and forcing lower-income and minority homeowners to live near these properties has, over time, almost guaranteed that homeowners in lower-income white, black, and Latino neighborhoods do not reap the same financial homeownership benefits that the owners of homes in higher-income, predominantly white neighborhoods receive.

SOCIAL BENEFITS

U.S. housing policies support and subsidize home purchases because homeownership purportedly provides positive benefits for owners, neighborhoods, and communities. Specifically, housing policies favor homeownership based on the assumption that homeowners are more involved in their communities and actively participate in homeowners' associations and other local civic organizations. In the Happy Homeownership Narrative, homeownership is good for all property owners who live in owner-occupied neighborhoods because homeowners take good care of their homes and ensure that their neighborhoods remain safe and desirable. Because people are more likely to take better care of the things *they* own than the things they use but *others* own, homeowners should be expected to repair, improve, and perform routine maintenance on their homes.

U.S. housing policies are correct to assume that actual and potential homeowners are affected by how homes are maintained in a neighborhood and the types of amenities the neighborhood has. Appraisers assess the value of surrounding properties when calculating the value of a home. Thus, appropriately maintained homes generally have higher property values. Just as they lobby to fence out undesirable uses, actively involved homeowners frequently lobby local governments to ensure that they have high-quality amenities (like new roads and improved schools) in their neighborhoods and communities.

In addition to enjoying these neighborhood amenities while they remain in their homes, existing homeowners benefit from living near well-kept homes in desirable neighborhoods when they decide to sell their homes, because when potential homeowners consider whether and where to buy a house, they evaluate the amenities in the house *and* in the neighborhood. Potential buyers consider things like: Who are the other neighbors? How well do they maintain their homes? Are the schools and other community facilities and services of high quality?

U.S. housing policies also encourage and subsidize homeownership because of the belief that being a homeowner makes you happy and is good for school-age children. Homeowners regularly report that owning their own home makes them feel good, that they believe that owning a home is better emotionally and psychologically for their households, and that they derive pleasure from living in their particular home or neighborhood. Renters with young children are especially likely to aspire to become homeowners because of the belief that children who live in rented housing are deprived of valuable educational and societal benefits that automatically flow to homeowners' children. Although inconclusive, most studies do show that homeownership provides social, psychological, and emotional benefits for homeowners' children that renters' children do not receive, and data confirm that homeowners' children perform better in school and on standardized tests than renters' children. Studies further suggest that owner-occupied housing generally is a happier and healthier environment in which to rear children.[5]

While some of these myths and assumptions are true, not all are. Neighborhoods that consist of homeowners are neither necessarily nor always "better" than a primarily renter-occupied neighborhood. Furthermore, homes in owner-occupied neighborhoods are not guaranteed to have higher market values than homes in neighborhoods that consist primarily of renter-occupied housing. Likewise, renters can obviously be just as responsible and involved in their communities as homeowners can. Whether the assumptions and myths associated with homeownership are valid or not is largely irrelevant. Since the Depression, U.S. political leaders have justified enacting and protecting housing policies that encourage and heavily subsidize homeownership because of the financial and positive external benefits that purportedly flow to neighborhoods and communities when people own their own homes. Given that

5 Donald R. Haurin et al., *The Impact of Homeownership on Child Outcomes* 10 (Joint Ctr. for Hous. Studies, Harvard Univ., Working Paper No. LIHO-01.14, 2001), *available at* http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/liho01–14.pdf.

most Americans also continue to believe that homeownership is better than renting, no one really seems interested in examining whether the myths and assumptions about homeownership are actually true.

BENEFITS TO THE U.S. ECONOMY

Homeownership might not provide the financial and psychological benefits portrayed in the Happy Homeownership Narrative. But, it is undeniable that homeownership has positive economic spillover effects and significant economic benefits for the U.S. economy. Indeed, the strength of housing markets has long served as a bellwether for the general strength of the U.S. economy. And, as the recent Great Recession demonstrated, weak housing markets create volatility across the spectrum of credit markets both in the United States and abroad. Until the recession (which started in December 2007 and officially ended in June 2009), consumer spending accounted for 70 percent of all economic activity in the United States and housing-related revenue *alone* regularly accounts for almost a quarter of the U.S. economy.

A robust housing market where people buy and sell houses and repay or refinance mortgage loans is good for builders, realtors, banks, and home improvement stores. Builders must purchase construction materials and homeowners must furnish their new homes, so having a robust housing market increases overall demand for consumer goods and services. Because people are needed to design, construct, and rehabilitate homes, an active residential real estate market also helps boost local employment rates. Localities welcome builders of single-family housing, *especially* expensive homes, because the housing sector invigorates other economic activity. Additionally, cities encourage and recruit potential owners to houses in economically depressed neighborhoods that are being revitalized or gentrified because of their desire to invigorate those neighborhoods. Given these overall benefits to the economy, national, state, and local leaders not surprisingly support laws that encourage and subsidize home sales. As discussed in more detail in later chapters, however, U.S. housing policies now seem more focused on boosting the economy and ensuring the financial well-being of the real estate and the financial services industry than supporting the people who are being encouraged to buy houses.

MORTGAGE INNOVATION TO THE RESCUE

As discussed in greater detail later in Chapter 3, starting in the 1970s, housing prices soared and housing price appreciation made some homeowners, especially the ones who owned homes in high-income communities, house-rich. Since the 1970s, however, wages for all but the most highly paid have been stagnant, real median household income has declined, and the savings rate has hovered at or below zero. By the late 1990s, housing price increases created a housing unaffordability problem, and many low- and moderate-income (LMI) renters who wanted to become homeowners found that they simply could not afford to buy a house because of the combination of stagnant wages, no savings, and escalating housing prices. LMI buyers found themselves priced out of most housing markets, *especially* high-appreciating markets, and many could not qualify for a traditional fixed rate mortgage (FRM) because their financial profiles did not match the profile envisioned in the Happy Homeownership Narrative.

Increasingly, LMI renters had no money to make a down payment. Their stagnant or declining income did not give them enough monthly disposable income to repay a fixed rate, fifteen- or thirty-year mortgage loan, and their crushing debt levels prevented them from satisfying lenders' debt-to-income ratio requirements. Americans were sorted into the housing haves and the housing have-nots who would never buy a home and experience the benefits promised by the Happy Homeownership Narrative.[6]

The U.S. government became concerned that homeownership was becoming unaffordable and, again, intervened in the housing finance market. To address this unaffordability crisis, the Clinton and George W. Bush administrations, as well as members of Congress, developed strategies and initiatives to make it easier for people to buy homes. The U.S. government explicitly encouraged lenders to "innovate" their mortgage products to create new loans that would make it easier for buyers to purchases houses. The innovated products helped increase home sales, but ultimately did not help renters become long-term homeowners.

The lending industry created and extensively marketed a wide array of nontraditional mortgage products. As discussed in more detail in later chapters, these innovations succeeded in causing overall homeownership rates to increase in the late 1990s and then skyrocket to reach a record high of 69 percent by 2005.[7] The nontraditional (also called exotic or alternative) mortgage products renters used to buy homes during the housing boom would

[6] The president of the National Association of Realtors testified before Congress that the affordability crisis had created a nation of "housing haves" (who purchased homes before the price explosion) and "housing have nots" (who were forced to "scale down their expectations and make lifestyle sacrifices to afford adequate shelter"). *Hearing before the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate, on Increasing Minority Homeownership, and Expanding Homeownership to all Who Wish to Attain It*, 108th Cong., 1st Sess. (Jun. 12, 2003) (prepared statement of Cathy Whatley, President of The National Association of Realtors).

[7] U.S. Census Bureau, *Housing Vacancies and Homeownership*, tbl. 14, *available at* http://www.census.gov/housing/hvs/data/histtabs.html.

have been unrecognizable to lenders in the 1940s–1970s. Until recently, the only borrowers who could qualify for low-cost, low-risk fifteen- to thirty-year FRMs were people who had good credit, consistent income, and made a down payment on the home purchase. To keep homeownership rates and home sales high, lenders essentially abandoned the underwriting criteria they had used for most of the twentieth century and approved mortgage loans for borrowers with bad credit or borrowers who could not (or would not) document their income and assets. Additionally, borrowers were approved for loans to buy a house even if they made low (or no) down payments. In fact, lenders innovated mortgage products to keep the initial monthly loan payments low enough to allow borrowers with unsteady or stagnant income and no savings to qualify for a mortgage and become homeowners.

Even though homeowners in the Happy Homeownership Narrative are thrifty savers, the very structure of these innovated loans discouraged households from being thrifty or financially responsible. Historically, cash-strapped renters had an economic incentive to be thrifty savers because they needed money for a down payment in order to qualify for a mortgage loan and then needed to save enough money from their paychecks to make fixed monthly payments on that mortgage loan. During the "innovation" phase of the housing boom, though, lenders effectively discouraged borrowers from exercising thrift and financial responsibility when they created exotic mortgage products that did not require borrowers to make down payments. In addition, because many of these products had adjustable-interest rates with low initial "teaser" payments that sometimes covered only the interest on the loans, borrowers had no incentive to save or be financially prudent, even though monthly payments on these exotic loans would increase, sometimes dramatically, when the initial teaser interest rates reset.

Mortgage innovation seemed to "fix" the unaffordability problem by allowing cash-strapped renters to buy their homes. Even though the exotic mortgage products were high-cost and high-risk, homeowners assumed that home values would keep rising and lenders would always refinance the loans. As long as housing prices rose but interest rates remained low, this was a reasonable assumption. So, at least for a while, becoming a homeowner helped households increase their net worth, and this mortgage fix helped perpetuate the myth that homeownership remained attainable and financially advantageous for all potential buyers. Unfortunately, homeowners' assumptions about their high-cost, high-risk exotic loan products and their miscalculations about U.S. housing markets were fatally flawed.

When interest rates reset, monthly payments increased – often dramatically – on these loans. By the time the housing market started to collapse