MESSAGE FROM THE PRESIDENT GEORGE W. McCARTHY

Protecting a Share of the Housing Market

PEOPLE WHO WORK WITH ME ARE OFTEN SURPRISED BY THE EXTENT TO WHICH MY PHILOSOPHICAL CANON DERIVES FROM LOW-BUDGET OFFBEAT FILMS, typically from the 1980s. When in need of wisdom, I frequently turn to the teachings of *Repo Man* or, for this essay, Terry Gilliam's allegorical masterpiece *Time Bandits.* In the movie, a group of public workers are employed by the Supreme Being to fill holes in the time-space continuum left from the haste of creating the universe in seven days: "It was a bit of a botched job, you see."

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Like the Time Bandits, policy makers are often tasked to fill holes—actual potholes in roadways, or more theoretical holes that are the artifacts of dysfunctional private markets. One big hole that policy has struggled for decades to fill is the inadequate supply of affordable housing. For example, housing economists in the United States have become quite adept at tracking the size of the hole, which has only become harder to fill since the federal government committed to address it as a national policy priority beginning with the Housing Act of 1949, part of President Harry S. Truman's Fair Deal.

Perhaps our collective failure to solve the affordable housing deficit over the last 66 years stems from wrongheaded analysis of the problem, and the conclusion that market-based solutions can be designed to solve the mismatch between the supply of affordable housing and demand for it. In his 1949 State of the Union address, President Truman noted that to fill the needs of millions of families with inadequate housing, "Most of the houses we need will have to be built by private enterprise, without public subsidy."

To support this claim, permit me a short departure into market theory. From the now-preferred mathematical approach to economic analysis, a market is simply a system of partial differential equations that is solved by a single price. The partial differential equations capture the complex decisions made by consumers and producers of goods, reconciling tastes, preferences, and budgets of consumers with the technical complexities of producing goods to arrive at a price that clears the market by settling all transactions that suppliers and consumers of goods are willing to make.

Acclaimed economists Arrow, Debreu, and McKenzie proved the theoretical existence of a single set of prices that can simultaneously solve for the "general equilibrium" of all markets in a national or global economy. One important aspect of this Nobel Prize–winning contribution was the observation that a unique price cleared each market—one market, one price. There was no expectation that a single price could maintain equilibrium in two markets. But this is the fundamental flaw of the housing market—it is actually two markets, not one. Housing markets supply both shelter for local consumption and a globally tradable investment good made possible by broad capital markets that serve global investors. This dual-market status used to be more descriptive of owner-occupied housing, but, with the proliferation of real estate investment trusts (REITs), rental markets are now in the same boat.

Markets for consumption goods behave very differently than investment markets, responding to different "fundamentals." On the supply side, prices for consumption goods are dictated by production costs, while prices in investment markets are dictated by expected returns. On the demand side, such things as tastes and preferences, household incomes, and demographics determine the price of housing as shelter. Investment demand for housing is dictated by factors like liquidity and liquidity preferences of investors, expected returns on alternative investments, or interest rates.

In developed countries, global capital markets and the market for shelter collide locally with little chance of reconciliation. Local households compete with global investors to decide the character and quantity of housing that is produced. In markets that attract global investment, plenty of housing is produced, but shortages of affordable units are acute, and worsen over time. This is because a huge share of new housing is produced to maximize investment return, not to meet the needs of the local population for shelter. For example, there is no shortage of global investment willing to participate in developing $100 million apartments in New York City. But affordable housing, being much harder to finance, is in short supply. And in markets that have been abandoned by global capital, house prices fall below production costs, and surplus housing accumulates and decays. In extreme cases such as Detroit, market order can only be restored by demolishing thousands of abandoned homes and buildings.

Perhaps it is time that we reconsider the analysis that led President Truman, and thousands of housing policy makers after him, to conclude that one could forge market-based solutions to the challenge of sheltering a country's population. Truman concluded that "By producing too few rental units and too large

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a proportion of high-priced houses, the building industry is rapidly pricing itself out of the market." But Truman was thinking about the market for shelter, not investment. It is remarkable to note that the number of housing units supplied in developed countries such as the United States significantly exceeds the number of households. In 2010, the U.S. Census estimated that there were 131 million units of housing in the country and 118 million households—one in seven housing units were vacant. It is even more shocking to note that in the United States this oversupply of housing characterizes every metropolitan market in the country—even metropolitan markets with extreme shortages of affordable housing. In 2010, 8.5 percent of housing units were vacant in Greater Boston, 9.1 percent in the San Francisco Bay area, and 10.2 percent in Washington, DC. The problem is that many households have insufficient incomes to afford the housing that is available.

In the end, rather than fill the holes in the fabric of time and space, the Time Bandits decided to take advantage of them to "get bloody stinking rich." The bandits sought to capitalize on celestial imperfections in the same way that global investors seek returns from short-term market dislocations. To illustrate the dangers of naked speculation in unregulated markets, consider an apocryphal tale from a very different market. In 1974, heavy rains during planting season in Bangladesh suggested that rice might be in short supply at harvest time. In anticipation of these shortages, rice prices started to rise. Savvy commodity speculators realized that there would be a good return on any rice that was held off the market. Despite the fact that the actual harvest produced a bumper crop, the interaction

Tassafaronga Village in East Oakland, California, set a new standard for energy-efficient, beautifully designed affordable housing when it opened in 2010. Credit: David Baker Architects.

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between market expectations and market manipulations by commodity investors produced one of the worst famines of the 20th century—with an estimated 1.5 million famine-related fatalities. The famine was not the result of real food shortages. The collision of the market for goods and the market for speculative investment priced rice out of the reach of the local populations, with landless families suffering mortality at three times the rate of families with land.

Perhaps shelter and food are too important to be left to unregulated markets to allocate. In light of the damage that the conflict between the market for goods and the market for investment can inflict on local populations, perhaps public policy should focus on protecting a share of the market—and the public—from the ravages of speculation. In this issue, we describe some nascent efforts to produce permanently affordable housing by insulating it from speculation—through community land trusts, inclusionary housing, and housing cooperatives. Miriam Axel-Lute and Dana Hawkins-Simons discuss the mechanics of organizing local community land trusts. Loren Berlin describes efforts to preserve affordable housing in the form of manufactured homes and to promote permanent affordability of that stock through the conversion of manufactured housing communities to limited equity cooperatives.

On more cautionary notes: Cynthia Goytia discusses the ways that low-income communities circumvent housing regulations that drive up housing costs to produce their own affordable but substandard shelter in informal settlements around Latin American cities; and Li Sun and Zhi Liu discuss the tenuous status of one-quarter of urban Chinese households that purchased affordable shelter with uncertain property rights on collectively owned land at the rapidly developing edge of cities and in "urban villages," former rural settlements now surrounded by modern construction. As capital markets deepen in these countries, the competition between housing as investment good and housing as shelter will likely exacerbate informality in Latin American cities and make property rights of these Chinese families more precarious. After almost seven decades of failed efforts to get private markets to meet populations' needs for affordable shelter, it might be time to develop, and to export, another approach that is based on a more realistic understanding of the complexity of housing and capital markets. L