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Beyond the Recession: The Great Housing Rebalance

Introduction

Thank you for the opportunity to speak today.

Your gathering takes place at a pivotal moment for housing in the United States.

The ravages of the housing collapse and the broader recession it precipitated remain in painful evidence.

Since the peak of the housing bubble, home prices across the nation have fallen by an average of 18.5 percent, a trend that has continued through the fourth quarter of 2010. The 100 largest metros have fared, on average, even worse, with home prices decreasing by 23.6 percent from peak value in 2006.

But the impact of the housing crisis has not been uniform.

Some states, such as Texas, have weathered the housing crisis better than others, and some of its metro areas have recently even seen growth in home prices. Others, like Florida, California, Arizona, and Nevada, continue to be the hardest hit areas, with home values declining by over 50 percent in some metro areas since the housing crisis began.

Michigan's large metros were almost as hard hit by the housing downturn as many of the Sun Belt metros. In the Detroit Metro area, home prices have fallen by 42 percent from peak value in 2005, and have continued to decline through the fourth quarter of 2010. Grand Rapids has also experienced a steep decrease in home values, declining across the metro by 26 percent since 2005.

These metros also rank among the worst performing in terms of home foreclosures. In Detroit, there are approximately 12 bank-owned homes per 1,000 mortgageable properties and nearly seven out of every 1,000 in Grand Rapids. By contrast, the average across the top 100 metro

areas is five and the average for the entire United States is four per 1,000 mortgageable properties.

As bad as these barometers are, they would be a lot worse if the federal government had not taken aggressive steps to prevent foreclosures, stabilize hard hit neighborhoods, boost demand, ensure access to capital and put in place a regulatory architecture to protect consumers and curb abuses going forward.

My remarks today, however, are not focused on the past or even the present. I want to focus on the future of housing and housing policy in the United States.

Like the Great Depression, the Great Recession is a turning point for the American economy generally and the housing sector specifically. Simply put, there will be no return to normal since what preceded the recession was anything but normal

It is not sufficient to simply clean up the mess and move on. We need to deliberately, purposefully engage in a broader restructuring of housing policy that aligns with profound demographic, environmental and economic changes underway in our country.

We must, in short, ensure that the Great Recession is followed by a "Great Housing Rebalance."

I believe this rebalancing should have three central components.

First, we must drive a rebalancing between homeownership and rental housing. As HUD Secretary Shaun Donovan said in congressional testimony last year, "The crisis reaffirmed the need to achieve a better balance between ownership and rental housing and to provide more options—and better options—for families." He is absolutely on target. Current policy has distorted tenure choices in the United States. That needs to change to align housing policy and production with the demographic transformation underway in the nation.

Second, we must drive a rebalancing between housing and the environment, at the scale of both individual buildings and the built environment writ large. Residential housing and the built environment are major contributors to energy consumption and global warming. It is inconceivable that we can meet new energy and environmental imperatives unless we rewire the housing sector and development patterns more broadly for reduced energy.

And, finally, we must drive a rebalancing between the housing sector and the productive, trade-able sectors of our economy. The Great Recession has been a wake up call for this nation. It revealed an economy dangerously out of whack, characterized by debt, frenzied with consumption, where housing became a leading rather than derivative sector.

We must now move to an economy that is driven by exports, powered by low carbon, fueled with innovation, and rich with opportunity. We must make things again in the U.S.

Housing will necessarily take a secondary, more appropriate role in this next economy. But this doesn't mean that housing outcomes will worsen. In fact, just the opposite. If we build a productive and sustainable economy, more people will be employed with better wages and more decent benefits. If anything, the housing outcomes should be improved.

As a recent Wall Street Journal op-ed put it: "American policymakers got it backwards: In the long run, jobs support housing, not the other way around."

Achieving this "Great Rebalance" will require major shifts in policy and dramatic change in how markets function. Positive steps are already underway and smart proposals are under consideration. But make no mistake. To do what I am proposing will require some significant reforms to some of the most sacred elements of housing policy, including the mortgage interest deduction.

So let's start with my first proposition. In the aftermath of the recession, we must drive a rebalancing between homeownership and rental housing.

This rebalancing, of course, is already underway. According to the U.S. Census Bureau, the homeownership rate in the US peaked at 69 percent in mid decade and fell to 66 percent by the end of 2010. A March 2010 report by the Urban Land Institute predicts that the rate will continue to fall to the low 60s in the coming years.

Michigan's homeownership rate is higher than the national average, at 74 percent, but it has also fallen from a peak of 77 percent in 2008.

The tumble in the homeownership rate is not surprising given the wreckage of the housing-led recession.

The cascading of foreclosures. The ruining of credit. The tightening of lending.

But this is not just a case of a short term drop. The U.S. is a nation in demographic transformation.

We are a growing nation. Our population exceeded 300 million back in 2006 and we are now on our way to hit 350 million around 2025.

We are a diversifying nation. An incredible 83 percent of our growth this decade was driven by racial and ethnic minorities.

We are an aging nation. The number of seniors and boomers exceeded 100 million this decade.

These demographic changes have profound consequences for housing. A recent ULI report concluded that four demographic groups will drive housing markets for the next decade:

- Older baby boomers, who will live longer than previous generations and constitute a senior population unprecedented in size

- Younger baby boomers, many of whom will be unable to sell their current suburban homes to move to new jobs

- Generation Y, which will be renting housing far longer than did past generations, partly because of crushing college debt

- Immigrants and their children, who will want to move to the suburbs but may find housing there too expensive even after the current drop in prices.

As the report nicely summarizes, "demographics are destiny" and these demographic forces favor rental housing at levels unprecedented in decades.

Those levels have been calculated by the Harvard Joint Center for Housing Studies: By their estimate, the total number of renters will likely rise by some 3.8 to 5 million between 2011 and 2020.

This shift in consumer realities requires a serious rededication of energy and talent to constructing a new rental housing policy for the nation.

HUD will need to take action to preserve the subsidized rental stock that has been built under a broad array of programs over the past 75 or so years. To that end, I thought the administration's Transforming Rental Assistance proposal last year was one of the most important and innovative proposals in decades.

Any effort to restructure Fannie Mae and Freddie Mac, the secondary mortgage market institutions, must take into account the need to maintain a steady supply of affordable capital for multifamily housing. According to one estimate, "Ninety percent of the multifamily units financed by Fannie Mae and Freddie Mac over the past fifteen years (more than 10 million units) have been affordable to families earning incomes below the median in their metropolitan area." Multifamily finance did not cause the housing crisis, and so we should not throw out the multifamily housing finance baby with the single family housing bathwater

But federal reforms are not sufficient.

As everyone in this room knows, state and local ordinances and rules have a dramatic effect on the supply and location of housing. The interplay of state and local tax, land use, zoning building codes and resource allocation decisions have made it difficult to build the right stock in the right place.

The result: Subsidized housing tends to be disproportionately located in distressed inner city and older suburban neighborhoods because wealthier suburbs practice exclusionary zoning and limit affordable housing within their borders, and because states tend to favor central cities in the allocation of federal low-income housing tax credits.

This has a cascading impact on everyone in the region: exacerbating commutes, undermining opportunity, hindering matches between workers and employers.

The bottom line is this: Policies that cluster affordable housing in the urban core tend to further concentrate poverty in that area, and widen the distance between low-income residents and suburban job growth centers. Beyond that, they do not always match the geography of where the poor are living.

Brookings research shows that Michigan's suburban poor population has grown significantly over the past decade. By 2009, both Detroit and Grand Rapids metros had over 50 percent of their total poor populations living in the suburbs.

States and localities will need to make some tough decisions to increase the supply of affordable housing in both older communities and new growth areas:

- To make it easier to build housing in older communities, local zoning rules for downtown areas—as well as commercial and even industrial areas in cities and older suburbs—need to be reexamined and revised

- To make it easier to rehabilitate older buildings, state and local building codes need to be changed

- To make it easier to increase densities, states should permit—and localities should adopt – programs that allow the transfer of development rights from greenfields to urban communities

- To make it easier to build smaller apartments, the federal and state governments may need to provide greater access to market capital through new credit enhancement vehicles.

New affordable housing, of course, will need to be built in fast growing areas where jobs are increasingly concentrated. That will require a change in rules. Fast-growing counties should consider adopting inclusionary zoning ordinances that require a portion of all major subdivision developments to be affordable to low and moderate income renters.

Excellent examples include ordinances in counties like Montgomery County in Maryland and Fairfax County in Virginia and King County in Washington state.

The states should also examine where they are allocating the federal low income housing tax credits. Are they allocating the credits to developments in fast growing areas, helping to ease the imbalance between jobs and housing? Or are they continuing to allocate the credits to distressed inner city areas, exacerbating the spatial mismatch?

And, finally, the state and localities need to expand the supply of affordable housing in ways that support economic integration and mixed income communities. As discussed above, the spatial concentration of affordable housing in low-income urban neighborhoods could actually exacerbate sprawling development patterns. Thus, efforts to expand the supply of affordable housing must avoid the concentration of poverty.

That brings me to my second proposition. In the aftermath of the recession, we must drive a rebalancing between housing and the environment, at both the building scale and at built environment scale

The relationship between housing, energy, and climate change has become more apparent over the past several decades. Residential housing and the built environment more broadly are major contributors to energy consumption and global warming.

Residential buildings alone account for 20 percent of U.S. carbon emissions, with the vast majority coming from detached single-family houses. The average American home generates 20,000 pounds of carbon emissions annually due to the energy it uses, causing strain on both the environment and the residents who are forced to pay for rising utility costs.

The transportation sector accounts for another third of carbon emissions, in part because sprawling development patterns separate jobs and houses and, without adequate transit systems, necessitate car travel.

To address climate change and secure our energy independence, the United States must fundamentally alter how and where we build our dwellings.

Three actions are of paramount importance:

- Catalyzing the retrofit of existing homes and buildings;
- Promoting the green construction of new dwellings; and
- Promoting more environmentally sustainable development patterns.

Here, the federal government made enormous progress in 2009 and 2010.

The Recovery Act made historic investments in greening the public housing stock and, to a much lesser extent, the federally assisted portfolio.

HUD and DOE executed an unprecedented memorandum of understanding to link, leverage and align their disparate programs and efforts, particularly around the retrofit of multifamily housing.

HUD launched a Sustainable Communities Initiative, in close collaboration with DOT and EPA, to encourage unprecedented coordination between land use, housing, transportation and economic development decisions.

To coordinate all this and other actions, HUD has created and staffed up an Office of Sustainable Housing and Communities.

All of these reforms and initiatives have occurred in record time, under enormous scrutiny.

Now comes the hard part.

The Recovery Act funding is coming to an end. In the current fiscal and political environment, there is little prospect of additional funding at anywhere near the scale of 2009 and 2010.

So HUD and DOE, and the broader subsidized and unsubsidized sector, are going to need to get creative real fast.

The U.S. might look to the rising crop of "smart cities" in Europe and Asia, where global companies are helping to develop cities that will use technology to manage urban congestion, maximize energy efficiency, and allocate scarce resources based on real time evidence.

In Portugal, for example, the firm Living PlanIT is building a smart, green city called PlanIT Valley, which will be equipped with new technologies, such as an "Urban Operating System," an intelligent building system, and a vast network of sensors to monitor energy consumption and reduce waste. This new urban model has the potential to drastically improve energy efficiency and carbon emissions, as homes will use 50 percent less energy and 80 percent less water than traditional city homes. Living PlanIT hopes to eventually replicate their technology in other countries around the world.

On a broader scale, Germany has used sweeping interventions to make energy efficiency the norm in housing production and rehabilitation:

- The first intervention is comprised of several energy saving laws that require such things as 30 percent lower energy use in new and refurbished buildings, a higher proportion of heating costs to be consumption-based to incentivize energy saving, and that new buildings meet 15 percent of its heating requirements from renewable sources by 2020.

- The second intervention consists of government subsidized programs at the federal, regional, and municipal level that promote energy-efficient construction and energy savings.

- Lastly, the third intervention involves the German Energy Agency (DENA), which links together government activity, subsidy programs that promote energy efficiency, and market activities to provide information on funding programs and advice on energy saving.

These efforts in Portugal and Germany are good for the environment by lowering green house gas emissions, and for consumers by lowering energy costs. But they are also smart economy building efforts that create good jobs, drive investment and create new sectors of the economy.

That brings me to my final proposition. In the aftermath of the recession, we must drive a rebalancing between the housing sector and the productive, trade-able sectors of our economy.

The Great Recession has left a brutal legacy.

Nearly 9 percent of Americans remain unemployed. Just under half of those—about 45 percent—have been unemployed for 27 weeks or longer. In Michigan, more than one in ten are currently unemployed.

The number of people living below the poverty line jumped by four million between 2008 and 2009; 43.6 million Americans are now in poverty, one in seven.

The nation lost 8.8 million jobs over the course of the recession and we have regained only 17 percent of those in the last 18 months. Michigan lost over 400,000 jobs during the national recession (and many more throughout the past decade), and has regained about 19 percent of those lost during that time period.

With the housing market crippled, and credit ruined, domestic consumption will not lead economic recovery as in past recessions.

Rather, we are entering new economic territory, with demand led by rising nations like Brazil, India and China and the energy sector undergoing a disruptive transformation.

We need a new growth model, both to create jobs in the near term and retool our economy for the long haul.

So I make the following proposition, we must purposefully change the shape of the American economy from one characterized by housing debt, speculation and consumption to one that is driven by exports, powered by low carbon, fueled by innovation and rich with opportunity. This is a vision where we export more and waste less, innovate in what matters, produce and deploy more of what we invent and make education a competitive priority for the nation.

Why exports? Because the U.S. needs to reorient our economy to take advantage of this demand coming from the world's rising nations that are rapidly urbanizing and industrializing. We have

crossed an economic Rubicon. Brazil, India, and China—the BICs—are expected to account for about a fifth of the global gross domestic product in 2010, surpassing the United States for the first time. This will grow to more than 25 percent by 2015.

Growth in the BICs—and in their bursting cities and rapidly expanding middle class—means new fertile markets for American goods and services. So let's visualize an economy where more firms in more sectors trade more goods and services seamlessly with the world.

Why low carbon? Because we are witnessing a global green economic revolution, as powerful and disruptive in scale as the technological revolution underway since the inception of the internet.

This is not a shift to a green economy, but a greening of the broader economy which will change everything … the energy we use, the infrastructure we build, the products we buy, even the homes we live in and the office and retail buildings we frequent.

Make no mistake. This is about markets as much as the environment. And America must not only lead the global transition to sustainable growth but use breakthroughs in technology and practice to spark a production revolution at home.

Why innovation? Because continuous innovation is the driver of economic productivity and growth. Innovations in computers and telecommunication enabled the information revolution. The United States must strive to be the world's "Innovation Nation," a hot house of ideas and invention and the platform for advanced production.

Why opportunity rich? Because the next economy offers the best chance to grow jobs that pay decent wages and provide decent benefits. The prior economy drove income inequities in this nation; the next economy must drive economic inclusion, social mobility and social cohesion.

Building this kind of economy will not just happen.

It will require purposeful and deliberate actions at all levels of government, in close collaboration with the private and voluntary sectors.

Here we find our competitors moving at lightening speed, while we dither and debate.

Established nations like Germany and rising nations like China, India, and Brazil are making transformative investments in renewable energy, in modern ports, in high speed rail, in metropolitan transit—where metropolitan areas like Munich and Stuttgart and Shanghai and Sao Paolo – are acting with singular competitive purpose.

Unless America acts, we run the risk of ceding our preeminent role in the global market to our competitors. Europe and Japan will satisfy the demand for goods and services from rising nations. China will dominate the transition to the low carbon economy. Innovation will drift

abroad to firms and research institutions that seek to emulate what we already have. Our standard of living, already under stress, will decline further.

It is time to get our act together.

The following three part playbook will stimulate the job creation and economic restructuring we desperately need.

First, we need to *Invest in the assets that drive the next economy*. The U.S. must get its fiscal house in order. But we must also invest in the things that matter:

- Advanced energy research and development to crack the code on low carbon and generate the next production of products
- Advanced manufacturing to ensure that the US remains an engine of production
- Transformative infrastructure to move goods, services, people, energy and ideas efficiently and effectively; and
- Education and skills to give our workers what they need to compete globally.

We also need to deliver these investments in new ways, through new public/private institutions. The current suite of legacy governmental institutions will not, for the most part, deliver the next economy. We need a new network of market-oriented, private-sector-leveraging, performance-driven institutions:

- Energy discovery innovation institutes
- Laboratories for advanced manufacturing
- National and state infrastructure banks
- Urban land banks, just to name a few.

Second, we need to leverage investments in place through smart metropolitan strategies.

The prior consumption economy had a remarkable uniformity across the national landscape. A Wal-Mart in suburban Detroit is virtually the same as a Wal-Mart in suburban Denver. Same footprint. Same products. Same financing model. Same low wages!

But Detroit exports a very different set of goods and services than Denver.

Detroit's niches in the low carbon economy are completely dissimilar.

And what makes Detroit innovative is not what makes Denver innovative.

In our view, our transition to the next economy requires Detroit and each metropolitan area to build on their special assets, attributes and advantages and strengthen their strengths.

This is a different kind of growth … purposeful, deliberate, collaborative.

To do this, Brookings believes we must adapt the practice of private sector planning to metropolitan economic development, and create what we call "metropolitan business plans."

The secret of metropolitan business plans? It's not that complicated. Be cognizant of your special assets. Be strategic in design. Be intentional in your actions. Be aggressive in your advocacy.

Brookings is currently working with teams of political, business and civic leaders in Northeast Ohio, Minneapolis-St. Paul and Greater Seattle to pioneer metropolitan business plans. These very disparate places have settled on three very distinct plans to reflect their distinct economies: retooling manufacturing firms and retraining industrial workers in NE Ohio; spurring entrepreneurial activity and commercialization of innovation in the Twin Cities; and becoming the global hub of building energy efficiency technologies in Greater Seattle.

To transition to the next economy, Michigan's metros must embrace intelligent economic design and use the practice of metropolitan business plans to leverage their own unique and considerable assets.

Finally, given fiscal constraints, we need to make some hard choices.

We need to cut to invest.

That means shifting funds from current legacy programs that lack accountability and impact.

That means downsizing consumption oriented tax expenditures, particularly around real estate and housing.

Let's stop fueling the old economy's bad habits of consumption, exemplified by the huge tax subsidies we provide for consuming more and more expensive housing. Incredibly, the amount the government forgoes from the mortgage interest deduction is projected to grow from $79 billion in FY 2010 to $150 billion in 2016. What if we capped these expenditures at the current level, and dedicated half of the savings to lowering the federal deficit and the other half, some $35 billion a year, to productive growth?

In Michigan, capping the mortgage interest deduction and using the savings to invest in advanced manufacturing or export promotion or technological innovation could provide significant benefit to the state's economy, which is only just beginning to recover from an almost decade-long recession. This deduction disproportionately benefits only a quarter of all taxpayers, primarily those with higher than average incomes, large mortgages, and second homes.

Both Michigan's median household income and average home prices in the state's major metros fall below the national averages, and Michiganders receive 25 percent less benefit per capita

from the mortgage interest deduction than the U.S. average and over 50 percent less benefit per capita than residents of states like California, Connecticut, and Maryland.

Shifting federal dollars from consumption-oriented tax expenditures to investments in productive next economy assets makes enormous sense for Michigan, given your strengths in manufacturing and exports.

Conclusion

Let me end where I began. The Great Recession has been a wake up call.

For too long, this country has acted as if housing and consumption could drive our economy.

We have allowed manufacturing and production and good jobs to drift abroad.

We have innovated in the wrong things.

It is time to get our act together.

I know many of you will question whether this country has what it takes.

Our federal government appears mired in partisan polarization and an ideological food fight.

But I believe Michigan has what it takes.

You have a pragmatic, pro-growth Governor.

You have a network of advanced research institutions and advanced manufacturing firms. You have a natural landscape that is literally second to none in this country.

And you have a network of leaders and practitioners who day after day prize place over party, collaboration over conflict, and fact over fiction.

The people in this room are card carrying members of this pragmatic caucus. You have the power and the smarts to deliver affordable housing and create quality places and by so doing contribute to the revival of this state.

The payoff will be greater economic vitality and sustainability and more and better jobs.