The Real Causes of Home Price Inflation

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The Growing Housing Affordability Gap

Mayor Paul Schell, during his campaign for office, promised to confront Seattle's growing housing affordability gap. The resulting Housing Action Agenda (1998) took a traditional view of the housing crisis by focusing on the supply and demand imbalance. The assumption is that by adding a large volume of market rate housing units, prices and rents will be brought down through the filtering process. A set of modest incentives to encourage new development activity forms the centerpiece of city's current housing policy.

The supply-demand view may be a valid way of looking at short term spikes in housing prices, but it is not a particularly useful way of addressing the housing affordability problem. The lack of affordability has been a long term trend since the late 1970's, and it is best described as the growing gap between rapidly rising housing costs and moderately rising household incomes.

A more effective way to solve the housing affordability crisis is to enable the housing market to produce housing at all income levels--by bringing down the most rapidly growing cost component of housing production, land values. In regional housing markets across North America there is strong evidence that rising residential land prices are largely responsible for driving the increase in housing costs. At the national level, residential land prices rose by 2,000 percent during the decades 1950 to 1990, compared to about 400% for building components and incomes.

In the Seattle market, the highest growth period for both home values and incomes occurred during the 1970s. The annual growth in King County median home value was 12.7% during that decade, while the rate for median income was 8.3 percent. Since 1977, median home prices have risen faster than median income. While incomes multiplied in the county by over 10 times during the total 40-year trend period (1950-90), housing values increased over 14-fold. During the past decade, household incomes have been growing at an annual average rate of about 6%, while total assessed land values have risen at the county-wide rate of about 8% annually.

Up-to-date trends are more alarming. In most Seattle city neighborhoods, median home prices experienced double digit inflation over the past two years. It is now difficult to find a habitable single family house for under $200,000. What is the driving force behind rapid appreciation in land values, often referred to in real estate circles as the "location" factor?

Factors Causing Land Price Inflation

Here are six interrelated factors that combine to bring about land price inflation:

Homeowner's expectations about equity build-up

In 1950, the $9,230 Seattle median priced home was easily affordable to the median income household. That family's $3,100 annual income was sufficient to purchase a dwelling priced at $15,800, leaving an income surplus of 30 percent. At mid-20th century, price increases were modest; mortgage interest rates were under 6 percent. Urban middle class families saw homeownership as a "hedge" against inflation.

Then, in the late 70's, a new mode of thinking began to unfold – the recognition that potential economic gains could be realized from shrewd real estate investments. Who can forget the proliferation of popular seminars promising quick returns to disciples of the "leverage" principle. This newly found source of windfall was coincidental with the era of the "exploding metropolis", characterized by rapid suburbanization and the phenomenon of *neighborhood dynamics*—push and pull factors causing the simultaneous rise and decline of socially disparate localities. Rapidly increasing urban mobility gave rise to the preeminence of location as the major factor in attracting real estate investments. "Sluming" was profitable in declining neighborhoods, and upgrading was profitable in rising neighborhoods.

By the 1990s, the information / service economy produced a new generation of explosive and concentrated wealth. Under the rapid pursuit of the American Dream, the housing market had been transformed from a supplier of shelter to a source of economic gain through equity accumulation. Those families without the capital resources to jump onto the equity bandwagon with a first-time home purchase are often left behind as the affordability gap widens. The federal minimum wage is now one-third of the amount needed to rent a modest 2-bedroom apartment in King County. This standard of housing, requiring an hourly wage of $15.50, is unavailable to almost half of the renters within the county.

Meantime, the prudent homeowner is in an acutely advantageous position. In the Seattle market, an "empty nester" household, after 3 typical moves into increasingly higher value homes, will derive enough resale proceeds to purchase a dream home priced 70 percent above the price which a first-time home buyer can afford (holding income constant). Experienced movers leverage themselves into higher value homes by applying resale proceeds towards principal, thus reducing monthly mortgage costs to an affordable level.

Landowners' practice of speculative holding

King County assessment records reveal the extent to which land values have been rising historically. Throughout the period 1977 to 1998, total land assessments increased by 945 percent. On the other hand, general monetary inflation has been growing at an average annual rate of about 4%, or 128 percent over the twenty-year period. In reality, the increase in value realized from a property's location amounts to speculative gain—reflected in land values. Thus, in the Seattle land market, the 817% net balance in land value inflation is independent of the individual investors' capital improvements and can be viewed as potential windfall. From the point of view of individual investors, buildings actually lose value over a period of time, eventually to the moment of zero at the end of their economic life. Assessors here usually assign a nominal improvement value ($1000) to a fully depreciated, deteriorated building.

Some shrewd investors will capitalize on the rising land market by purchasing properties in high value locations, letting existing buildings deteriorate while holding onto the land. Such is the case of landowner Sam Israel who over several years accumulated a portfolio of nearly 30 parcels of old commercial buildings in downtown Seattle. By 1996, his land value assessments had grown to $21 million, more than twice the value of the remaining buildings. Half of the

property inventory consisted of cleared sites or nominally valued buildings. Currently, the downtown construction boom has boosted true market land values far beyond these assessment figures. By way of illustration, the Douglas Hotel property was purchased for $16,000 and later resold for $1 million. The Samis land trust is now leveraging the value that its predecessor played no part in creating. In effect, the Israel speculative holdings contrived an artificial scarcity of land by withholding valuable sites from productive use.

Major landowners in rapidly suburbanizing areas of the metropolis can easily produce the same effect of constricting land supply by holding sites at the urban fringe while surrounding land escalates in value. The expectation of windfall gains from rising location values itself exacerbates inflationary pressures, as others join in the race for maximizing unearned profits from eventual resale at higher prices. This scenario literally played itself out in Clark County, Washington, during the early 1990s in anticipation of legal restraints on limitless urban expansion, accompanying the state's urban growth management act.

Builders' need to increase building-to-land value

As land prices rise, builders find that in order to make new homes marketable they must erect larger houses to increase the building value relative to the lot value. Homebuilders cannot market modest dwellings on expensive sites. What family will pay $300,000 for a 2-bedroom bungalow on a $150,000 lot? Sellers typically need a 2:1 ratio of building-to-lot value to attract homebuyers. The trend towards higher and higher land values leads to bigger homes, and higher developed-site prices.

Builders who choose to specialize in affordable housing are being driven away from neighborhoods rising in value. This is because the search for buildable lots priced low enough to allow affordable resale home prices is becoming increasingly difficult. Consider the following Seattle Times excerpt: "HomeSight, which helped ignite the Central Seattle housing craze by having the guts to build where no one else would, now finds itself priced out of the market it helped create. In the mid-1990's, it sold 18 new [affordable] houses for $135,000 each. One was recently re-appraised for $205,000. Looking at the astronomical prices for houses in the area, HomeSight is packing up and heading south to cheaper pastures." This course of defensive action, replicated in varying degrees throughout the urban region, feeds the neighborhood dynamics process, leading to further geographic concentrations of wealth and deficiency.

Real estate industry records show the distinct trend towards larger single family homes, which itself generates consumer preferences for more living space. New homes are 40 percent larger than they were in 1970 when the stage was being set for the commodification of housing. The median size of a new home was 1,605 square feet in 1985; by the end of the century that typical home size grew to 2,030 square feet. Home size is less a function of household size than a product of upgrading one's housing status.

Mortgage lenders' practice of leveraging

Higher developed site costs, including more expensive lots and larger homes, induces the use of highly leveraged long-term mortgages. But, reducing down payment costs by shifting the balance to monthly mortgage payments merely increases the total cost to housing consumers. Observe the long term trend towards greater and greater leveraging—the lightening of up-front costs and the loading of carrying costs. These hypotheticals are generated from historical data:

In 1950, the typical mortgage loan terms stipulated a loan-to-value ratio of 60 percent, on a 25-year loan at 5% interest. For the median income family purchasing a median priced home in King County, total ongoing housing costs amounted to 17% of household income. Total accumulated mortgage debt was $13,200 on a $9,230 house, for a debt-to-price ratio of 1.4. By 1970, the typical loan terms had changed to a higher leveraged 80%, 30-year loan. Nevertheless,

incomes nearly kept up with home prices; the ratio of housing costs to income rose slightly to 18.3 percent. The debt-to-price ratio rose to 1.9. See summary table 1.

By 1990, down payment on the median priced house had edged down to 10%, driving up the debt burden to a hypothetical 42.5% of median household income. Needless to say, many aspiring homeowners could not qualify under these conditions. For those who did, the debt-to-price ratio rose to an all-time high of 3.3. By comparison, the 1950 typical buyer paid out 40% more to the lender than the home price; the 1990 buyer's cost was two and a third times more than the purchase price, paid over the term of the loan. (It should be noted that the current debt-to-price ratio of about 2.8 is affected by lower interest rates.)

By now, housing prices are so high that lenders are finding ways to convert 95% or more of home value into mortgage debt. The effect is to allow more potential purchasers into the home buying market and to compete for higher price housing. However, this is accomplished through the social obligation of greater long-term debt, which coincidentally translates into greater institutional profits.

Brokers' practice of commission sales

For many years the real estate industry has clung to the practice of basing commissions on the sale price of homes sold by agents. The industry standard is a fixed 7 percent, despite the rapidly escalating home prices in some markets. Historically, the consumer price index in the Seattle region has increased at an average annual rate of 4 percent; household incomes have risen at the rate of about 6 percent. But commission fees, being pegged to home prices, are accelerating at rates closer to 8 and 10 percent.

This fee-basing system creates the incentive for real estate agencies to seek the highest price for homes, and to turn over home resales as rapidly as possible. It goes without saying that the industry benefits greatly from both (i) homeowners' tendency to build up equity through successive moves, and (ii) the push & pull forces of neighborhood dynamics, creating more reasons to move from comparatively lower value locations to higher value locations.

Earlier this year, the Seattle Times published a series titled "Sticker Shocked", listing detailed home price trends for several neighborhoods in the Seattle region. Some of the featured neighborhoods experienced a 15-year growth in housing prices averaging as high as 10 percent annually. In Capitol Hill, for example, the median priced $475,500 home had appreciated by nearly $361,700 over the growth period 1983-1998. When comparing the annual housing costs on this home to the annual equity gain, the calculated return on cost amounts to a generous 44 percent (see summary table 2). This exceeds by far any typical investment return in the financial market. By way of contrast, lower value neighborhoods such as Georgetown have been appreciating at the rate of 6 percent annually. This makes for a considerable difference in equity position. Here, the typical owner realizes a negative 23% return on cost. That is, the $5,050 annual equity gain compares unfavorably with the $6,215 in total annual housing costs.

Why do not homeowners resist the obligation to pay $35,000 sales commissions on $500,000 homes? Because of the prospect of ever-higher resale prices and the resulting proceeds. A few thousand lost in commissions can easily be recovered if an agent can bump up the price margin by tens of thousands. Nevertheless, the general public is beginning to question the wisdom of this shell game. Some nonconforming agencies are now offering lower percentage commissions, with the expectation that some day a fee-for-service system will prevail. Almost every other professional service in the U.S. economy bases fees on an hourly rate.

The perverse nature of the conventional property tax

The present property tax system is a good example of how perverse financial incentives lead to unrestrained land price inflation, disinvestment, and the over-consumption of raw land.

Under the present system where buildings and land are taxed at the same rate, owners have no incentive to invest in property improvements or more compact development, because doing so will result in higher taxes. Holding onto underutilized lots or letting buildings deteriorate results in lower taxes. Yet, housing affordability could be enhanced through greater site utilization or higher residential densities, because of lower per unit development costs. Thus, inherent in the equal rate method of property taxation is a built-in disincentive to utilize land more efficiently or to place it on the market at reasonable prices.

Land speculation leads to a tightening of the land market and further inefficiencies in the allocation of urban land resources. Even the region at large is impacted because jurisdictions are forced to increase taxes on productive properties to balance the losses from speculative holdings that are losing real or potential building value. Any tax tends to diminish the base upon which the tax falls. Because buildings constitute the greater portion of total assessed value, a tax burden falling mainly on improvements discourages capital investment in properties.

Inflationary land prices remain largely unaffected by the property tax which taxes land values lightly. Rising land costs are the major factor in driving up housing prices. If tax burden were shifted from building value onto land value (accomplished through differential tax rates), the property tax could put a damper on land price inflation. A land-based tax system would discourage land speculation and over time bring land prices into the range of affordability.

Conclusion

In the long run, what drives housing price inflation is the anticipation of financial gain, on the part of homeowners, landholders, homebuilders, mortgage lenders, and realtors. The interactions among these "stakeholder" groups provoke speculative tendencies in the housing market, and lead to the *commodification* of housing. This emphasis on the exchange value of housing is reflected in upward pressures on residential land values.

What is revealing about the factors contributing to rising land values is that none of them, with the exception of speculative land holding in predominantly developed areas, have anything directly to do with housing supply and demand. Thus, the strategy of increasing housing production is unable by itself to change the circumstances surrounding cost. Even the effort to increase residential land supply by expanding urban growth boundaries is based on a fallible argument because it will not curtail the propensity to speculate on fringe sites. It is essentially the amount of *speculation*, not the amount of *land* that governs home prices.

To be sure, housing price changes tend to occur in business cycles. Noticeable price spikes took place in Seattle's regional market at the closing years of the past several decades. Such cyclical events often trigger a burst of construction activity. But at no time do real estate investors and developers reach a point of meeting full demand, unless by collectively overshooting the anticipated market. A phase of slow activity then follows, until pent-up new demand precipitates another flurry of activity. In any case, effective demand does not extend down into the "affordable" range. The for-profit housing sector competes for the higher-end housing market. Increasing the supply of market rate housing will not be effective in bringing filtered-down units into the affordability range, because additional supply alone cannot bring down residential land prices. If indeed land value inflation is the principal cause of rising home prices, then it must be dealt with directly. The most effective means to secure housing affordability without committing immense public financial outlays is to devise financial incentives that discourage real estate speculation.

Table 1

AFFORDABILITY OF OWNER UNITS, 1950 - 1990 - KING COUNTY

Year	Median Household Income*	Median Home Value	Gross Annual Income Required	Total Monthly Housing Costs	Annual Income Surplus/Gap	Housing Costs as Percent of Income	Total Debt Service	Debt to Price Ratio
1950	$ 3,106	$ 9,232	$ 1,878	$ 44	$ 1,228	17.0%	$ 13,200	1.4
1960	$ 5,850	$ 13,900	$ 3,808	$ 89	$ 2,042	18.3%	$ 26,700	1.9
1970	$ 9,361	$ 21,700	$ 6,872	$ 160	$ 2,489	20.5%	$ 57,600	2.7
1980	$ 20,717	$ 71,700	$ 29,091	$ 679	$ (8,374)	39.3%	$ 244,440	3.4
1990	$ 36,179	$ 140,100	$ 54,858	$ 1,280	$ (18,679)	42.5%	$ 460,800	3.3
1999	$ 57,484	$ 214,000	$ 69,072	$ 1,687	$ (11,588)	35.2%	$ 607,320	2.8

* weighted median

DEBT-TO-PRICE RATIO

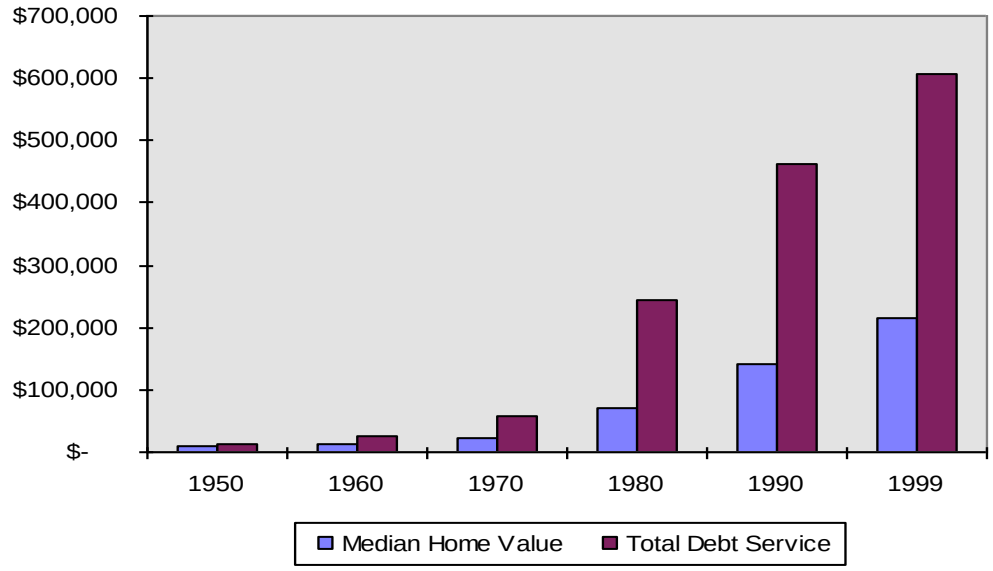

Table 2

15 YEAR GROWTH IN HOUSING PRICES, BY SELECTED NEIGHBORHOODS

Neighborhood	Extrapolated Median SF Home Price: Average Annual Growth Rt.	1983	1998	Cumulative Home Equity	Estimated Return on Cost: Average Annual Gain	Average Annual Cost *	Average Return on Cost
S. Park / Georgetown	6%	$ 54,244	$ 130,000	$ 75,756	$ 5,050	$ 6,215	-23%
West Shoreline	7%	$ 107,193	$ 295,750	$ 188,557	$12,570	$11,978	5%
North Greenwood	8%	$ 63,048	$ 200,000	$ 136,952	$ 9,130	$ 7,371	19%
Greenlake	9%	$ 76,857	$ 279,950	$ 203,093	$13,540	$ 9,037	33%
Capitol Hill-Montlake	10%	$ 113,831	$ 475,500	$ 361,669	$24,111	$13,405	44%

* mortgage principal & interest, taxes, insurance, maintenance