

# Rental Housing: Current Market Conditions and the Role of Federal Policy

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## Abstract

*This paper examines the impacts of the recession, the foreclosure crisis, and the freeze in the credit market on the rental housing market and the resulting implications for federal policy. In some markets, high rental vacancy rates, falling rents, and declining renter incomes threaten the financial viability of many rental housing properties. Rental housing property values have declined and delinquency and foreclosure rates are increasing. Fannie Mae and Freddie Mac now dominate the multifamily mortgage market. The reconstruction of the nation's housing finance system must include consideration of the financing needs of the multifamily mortgage market. The widespread recognition of the risks associated with homeownership demonstrated by the foreclosure crisis provides the opportunity to move to a national housing policy that levels the playing field between owning and renting. Scarce subsidy dollars should be more targeted to the neediest citizens.*

## Introduction

In the historic foreclosure crisis and the collapse of housing prices, policymakers and the press have focused virtually all of their attention on the owner-occupied housing market. Conditions in the rental housing market are also very difficult. Rental vacancy rates are at historic highs, rents are falling in many markets, and the incomes of renters are falling. Multifamily property values are falling and delinquencies and foreclosures in the multifamily mortgage market are on the rise. A growing number of properties have outstanding mortgage balances that exceed current property values; the number of rental properties with negative cash flows is growing. Most of the major providers of multifamily mortgages (commercial banks and commercial mortgage-backed securities [CMBS]) have exited the market. In the past 2 years, Fannie Mae and Freddie Mac have been responsible for funding 80 to 90 percent of new multifamily mortgage originations.

The current rental housing market conditions pose serious policy challenges. As the United States works through the housing crisis, many households that go through foreclosure will transition from homeowners to renters. With fewer homeowners, some portion of the foreclosed homeowner stock will enter the renter market. Who will own and manage those properties? The precarious financial position of rental properties could lead to disinvestment and, if these conditions persist, eventual abandonment. The biggest challenge facing the multifamily market is the credit crisis. As policymakers reconstruct the nation's housing finance system, consideration must be given to the credit needs of rental housing providers. The emerging consensus that homeownership is not for everyone provides the opportunity to rethink the roles of homeownership and rental housing in federal housing policy.

The next section of this article provides a description of current conditions in the rental market followed by a discussion of the effects of the foreclosure and credit crises on the rental market. The article then examines the expected changes in the housing stock to accommodate the decrease in homeownership. The article concludes with a discussion of short-term policy options to address current problems and suggestions for revamping the nation's housing policy over the long term.

## Rental Housing Market

Nationwide, more than 35 million households (one-third of total households) live in rental housing. More than 80 percent of these households (29 million) rent housing in the private market from landlords who receive no government subsidy. The subsidized privately owned rental stock houses about 5 million households; public housing provides homes for 1.3 million poor households.

The rental housing stock is quite diverse. In 2005, 25 percent of the rental units were single-family detached homes, 25 percent were in two- to four-unit buildings, and 11.4 percent of rental units were in structures with 50 or more units. The rental housing stock is distributed across the country, with 43 percent of rental units in central cities, 40 percent in suburban communities, and 17 percent in rural areas (U.S. Census Bureau, 2005b). A significant portion of the rental housing stock is old: 34 percent of rental units were built before 1960, and only 18.7 percent of rental units were built since 1990 (U.S. Census Bureau, 2005a).

The primary problem facing renters over the past few decades has been affordability. Much of the current research on rental housing demonstrates that low-income households spend larger fractions of their incomes on rent over time. DiPasquale and Murray (2008) showed that, between 2000 and 2005, real rents rose about 9 percent across 20 large metropolitan areas. During the same period, renter household income fell about 5 percent. The boom in homeownership during those years accounts for some of this income decline among renters as large numbers of higher income renters moved into the homeowner market (DiPasquale and Murray, 2008). Entering the recession, the real price of rental housing services was at its highest recorded level, while renters' incomes were lower than in 1970. Rent-to-income ratios were higher than they had been since the early 1930s.

The rental housing market is experiencing historic vacancy rates and declining real rents in most markets. In 2009, the rental vacancy rate peaked at 10.6 percent. In 2010, the rental vacancy rate was 10.2 percent. As shown in exhibit 1, high vacancy rates persist throughout the rent distribution,

**Exhibit 1**

**2010 Vacancy Rates by Rent**

Rent	Vacancy Rate
All specified renter units	10.6
Less than \$300	3.6
\$300 to \$349	9.1
\$350 to \$399	13.5
\$400 to \$449	13.1
\$450 to \$499	14.0
\$500 to \$599	11.1
\$600 to \$699	11.7
\$700 to \$799	10.9
\$800 or more	10.5
\$800 to \$899	11.4
\$900 to \$999	11.0
\$1,000 or more	10.0
\$1,000 to \$1,249	9.7
\$1,250 to \$1,499	9.0
\$1,500 or more	11.1

Source: U.S. Census Bureau, *Housing Vacancies and Homeownership (CPS/HVS)*; <http://www.census.gov/hhes/www/housing/hvs/annual10/ann10ind.html>

except for units that rent for less than \$300 per month; the vacancy rate for these units is 3.6 percent. For units with rents between \$300 and \$350, the vacancy rate jumps to 9.1 percent; for units with rents between \$350 and \$400, the vacancy rate soars to 13.5 percent. The declines in real rents observed during the recession translate into increased cash flow problems for landlords. For many renters, declines in rents have been outstripped by drops in income, making their already historically bad situation even worse.

**The Foreclosure Crisis in the Rental Market**

The current foreclosure crisis has significant impacts on the rental housing market. Large numbers of rental housing units are in buildings that have foreclosed or are at risk of foreclosure. The Joint Center for Housing Studies estimated that investor-owned one- to four-unit properties account for 20 percent of properties in foreclosure nationally (Joint Center for Housing Studies, 2008). Structures with one to four units are financed by single-family mortgages. About one-half of the renters in the United States live in one- to four-unit buildings.

Although data on the performance of single family mortgage investments are available, far less data are available on the performance of multifamily mortgages (mortgages on structures with five or more units). Those data that are available show considerable variation in the performance of multifamily mortgage loans. The Fannie Mae and Freddie Mac multifamily mortgage business has performed considerably better than their single-family mortgage business. In 2010, Fannie Mae reported a multifamily serious delinquency rate (60+ days delinquent) of 0.71 percent, up from 0.3 percent in 2008. Freddie Mac reported a multifamily serious delinquency rate of 0.26 percent, up from 0.05 percent in 2008. In 2010, the Fannie Mae and Freddie Mac single-family serious delinquency rates were 4.48 and 3.84 percent, respectively (Fannie Mae, 2011; Freddie Mac, 2011).

The Fannie Mae and Freddie Mac multifamily delinquency rates are substantially better than those for the multifamily CMBS. In 2010, the serious delinquency rate for multifamily CMBS reported by Trepp, LLC, was an astounding 13.6 percent.<sup>1</sup>

Although their multifamily investments are performing relatively well, both Fannie Mae and Freddie Mac have expressed concerns about this business going forward. In Fannie Mae's 10K filing for their 2009 fiscal year, they note that their 2007 multifamily loan acquisitions are showing signs of stress, which they attribute to the fact that the loans were acquired at the peak of multifamily property values. Since 2007, falling property values and rents have adversely impacted the financial viability of some of these properties. For Fannie Mae, 2007 vintage multifamily loans represent 24 percent of their 2009 multifamily guarantee business and 48 percent of their delinquencies (Fannie Mae, 2009a: 165). In their 2010 10K filings, both Fannie Mae and Freddie Mac indicate that they expect continued increases in nonperforming multifamily loans into 2011, despite some signs of stabilization in the national rental market. Both firms cite continued weakness in the overall economy; high unemployment; and the ongoing tough housing market conditions in some regions of the country (Fannie Mae, 2010: 6; Freddie Mac, 2010: 68). Arizona, Florida, Georgia, and Ohio account for only 10 percent of Fannie Mae's multifamily book of business, but 39 percent of their serious multifamily delinquencies (Fannie Mae, 2010: 170).

Shilling (2010) assembled new data on the financial condition of rental housing in Chicago and provides a detailed analysis of the impact of foreclosures on the rental stock in buildings with two or more units. The results of Shilling's analysis are certainly consistent with Fannie Mae's description of the national market and suggest continued increases in the number of rental properties in foreclosure. By the end of 2009, in Cook County, IL, foreclosed rental properties with two or more units contained about 32,000 rental units, a unit count which is similar to the 38,000 single-family homes that were in foreclosure. Shilling's data show that rental foreclosures are highly concentrated in low- and moderate-income neighborhoods.<sup>2</sup> In 2009, foreclosure rates on properties with two to six units range from 13.9 percent in low-income neighborhoods, to 10.8 percent in moderate-income neighborhoods, to 4.2 percent in high-income neighborhoods—up considerably from rates of 4.7, 2.3, and 0.5 percent, respectively, in 2005. In properties with seven or more units, 2009 foreclosure rates were 7.8 percent in low-income neighborhoods, 4.3 percent in moderate-income neighborhoods, and 2.1 in high-income neighborhoods, up from 2.3, 0.5, and 0.0 percent, respectively, in 2005.

Perhaps the most troubling result in Shilling's report is the significant decline in rental property values during the past few years. For larger properties with seven or more units, values have declined 26 percent since 2006; values of two- to six-unit properties have plummeted 46 percent since 2007. Shilling estimates that these declines in property values result in 30 percent of outstanding mortgages on rental properties being at risk of default. In addition, some portion of the foreclosed owner-occupied housing stock will be converted to rental housing, which will put additional downward pressure on rental property values.

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<sup>1</sup> Trepp, LLC, provided the author with data on CMBS multifamily serious delinquency rates.

<sup>2</sup> Low-income neighborhoods are defined as census tracts where median household income is less than 150 percent of the poverty level of a family of four in the 2000 Census. Moderate-income tracts have median incomes between 150 and 300 percent of the poverty level and high-income tracts have median incomes above 300 percent of the poverty level.

Shilling's results are based on only one county and, therefore, are difficult to generalize to the rest of the country. Widespread declines in rental property values, such as those found in Cook County, could substantially impact the rental housing market for many years to come. To increase the understanding of the state of the multifamily housing markets nationally, similar data collection efforts in more local markets are needed.

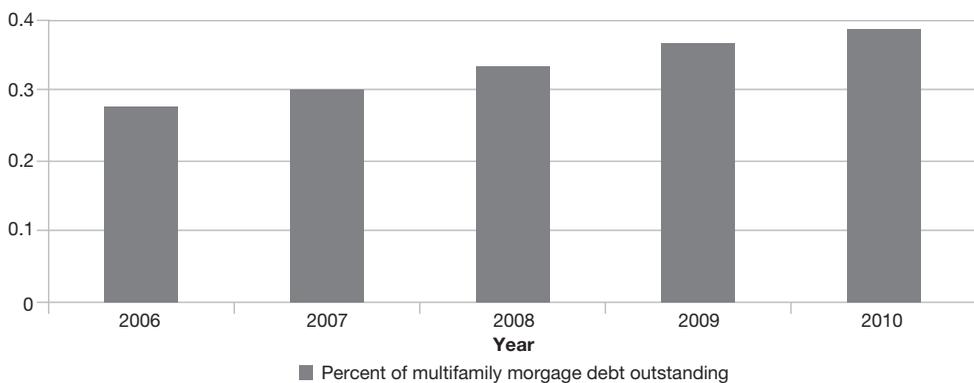
## Credit Crisis in the Multifamily Mortgage Market

The credit crisis is significantly affecting the multifamily mortgage market, which is defined as the market for mortgages on structures with five or more units. Banks have retreated from this market. In 2006 and 2007, Wachovia and Washington Mutual, Inc., were the top two multifamily mortgage originators nationally (together accounting for more than 18 percent of the market in 2006); both have been acquired by other institutions and have largely exited the market. The Mortgage Bankers Association reported a 67-percent decline in multifamily mortgage originations from a peak in the fourth quarter of 2006 to the fourth quarter of 2009. In 2008, conduits for CMBS had virtually disappeared from the market and currently show few signs of returning to the market (MBA, 2010).

Although traditional market participants retreated, Fannie Mae and Freddie Mac increased their market participation in 2008. In 2008, Fannie Mae and Freddie Mac funded \$35.5 billion and \$24.3 billion, respectively, of multifamily mortgages (Fannie Mae, 2009b; Freddie Mac, 2009). The government-sponsored enterprises (GSEs) funded between 20 and 30 percent of new multifamily mortgages in 2004 through 2006. GSEs funded between 80 and 90 percent of the new multifamily mortgages in 2008 and 2009. As shown in exhibit 2, as of the end of 2010, the GSEs held or guaranteed almost 39 percent of the outstanding multifamily mortgage debt, up from about 27 percent in 2006 (Board of Governors of the Federal Reserve System, 2011).

### Exhibit 2

Percent of Multifamily Mortgage Debt Outstanding Held or Guaranteed by GSEs



GSE = government-sponsored enterprise.

Source: Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States, Z1 Release*, March 2011, Table L219; (<http://www.federalreserve.gov/releases/z1/Current/z1r-4.pdf>)

The lending freeze by many traditional multifamily lenders and the increasing dependence on Fannie Mae and Freddie Mac for funding multifamily mortgages raises serious concerns about the future of multifamily mortgage market. Although the recession, particularly the job losses, has resulted in a downturn in new construction, demand for multifamily mortgages continues for refinancing and for purchases of existing buildings. From 2008 through 2010, Fannie Mae and Freddie Mac largely kept the multifamily mortgage market open. Given the uncertain futures of both Fannie Mae and Freddie Mac, there is reason for concern about the availability of multifamily mortgage financing to meet future financing needs.

Raising equity for multifamily projects became considerably more difficult in 2008 and 2009. Losses were common for apartment real estate investment trusts (REITs) and many lowered earnings expectations for 2010. The market for Low-Income Housing Tax Credits (LIHTC) had virtually disappeared in 2008 and 2009. In the early years of the LIHTC program, a diverse group of investors participated in the program. Tax credits were sold to individual investors via retail funds, and corporate participants represented a broad range of sectors of the U.S. economy. Over time, the financial services sector dominated the market for tax credits and corporate investors from other sectors of the economy decreased their participation in the market. For tax credit syndicators, financial services companies were very motivated customers. Banks could use the tax credit investments to meet Community Reinvestment Act requirements. Fannie Mae and Freddie Mac could use the tax credits to meet growing affordable housing requirements under their charters. With banks and Fannie Mae and Freddie Mac crashing and few nonfinancial services investors left in the game, the tax credit program ground to a halt. To address this issue, the American Recovery and Reinvestment Act (ARRA) of 2009 included a provision permitting state-tax-credit allocating agencies to receive up to 40 percent of their tax credit allocations in the form of cash to help fund stalled tax credit projects.

The LIHTC program appeared to be rebounding in 2010, when significantly more LIHTC equity was raised than in 2008 or 2009. Some investors, including insurance companies and some banks, returned to the market (Petherick, 2011). This rebound, particularly for new construction, is somewhat surprising given the high vacancy rates in the rental market and the number of foreclosed owner-occupied units that may ultimately convert to rental housing. The incentives provided by the LIHTC program may encourage more development than warranted given the soft conditions in the rental market.

The LIHTC program faces significant challenges going forward. Federal budget cuts and the possibility of substantial tax reform could eliminate or substantially alter the program. Many LIHTC projects depend on federal, state, and local subsidy dollars that may become scarce with the expected federal budget cuts and the dire fiscal conditions of many state and local governments. In addition, the uncertain role of Fannie Mae and Freddie Mac in the anticipated revamping of the nation's housing finance system could significantly impact the LIHTC market. Some LIHTC deals use their multifamily loan programs as a source of financing. In addition, both firms have substantial LIHTC holdings that could be sold as part of the restructuring or dismantling of these firms. Sales of these LIHTC holdings would compete with new LIHTC transactions for investors.

## **Rebalancing the Housing Stock and the Threat of Disinvestment**

Current conditions in the housing market raise important concerns about the future quality of the housing stock. The large number of homeowners losing homes to foreclosure will result in fewer homeowners, with a portion of that foreclosed stock entering the rental housing market. The foreclosed owner-occupied housing stock may provide new rental opportunities in communities that previously provided few, because of land use regulations and not in my backyard (NIMBY) concerns. Renters moving into such communities may now be preferred to the prospect of vacant, foreclosed properties.

Although the foreclosed owner-occupied stock may offer new opportunities for renters, the process of successfully transitioning large numbers of housing units from owner- to renter-occupied raises an important question: how fungible is the housing stock? In many growing, gentrifying urban areas in America, large numbers of rental properties have been converted to ownership properties, but there is far less experience with large numbers of ownership to rental conversions.

As stated previously, structures with one to four units account for 50 percent of the rental housing stock. A large fraction of these properties are owned and operated by small (mom and pop) investors. Who will invest in and operate the one- to four-unit properties available in the foreclosed stock as rental units? The number and capacity of mom and pop investors may be too small to absorb much of the owner-occupied foreclosed stock that will transition to renter-occupied. Larger private and nonprofit providers of rental housing tend to develop and acquire larger properties and seem reluctant to consider smaller one- to four-unit properties. Some larger rental housing providers have argued that because of the unique characteristics of each property, management costs are too high with scattered site one- to four-unit properties. To take advantage of the opportunities available in the foreclosed stock, developers and managers of affordable and market rate rental housing will need to consider new approaches to acquisition, development, and management.

Successful examples of managing single-family rental housing do exist. The Cleveland Housing Network (CHN) has extensive experience managing a lease to purchase program where single-family homes are developed or rehabbed under the LIHTC. The homes are rented for 15 years, with the goal of transitioning the unit to homeownership in year 16. Currently, CHN has 1,800 homes under management and has sold 500 homes (Durban and Whipkey, 2011). For this portfolio of homes, a property manager is responsible for managing 125 to 150 homes, which is comparable to the number of units assigned to many multifamily property managers.<sup>3</sup>

Foreclosures in condominium developments are common in many markets and present a unique set of challenges. Unit owners threatened with the prospect of foreclosure have little incentive to pay condominium fees. Condominium associations have few options to recover monthly fees. In large buildings with a substantial number of foreclosures or small buildings with just a few, the remaining residents face a substantial burden to maintain the complex and sustain the level of amenities.

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<sup>3</sup> The CHN provided data on units per property manager to the author.

In the existing multifamily rental stock, increases in the number of vacancies and foreclosures coupled with declines in property values, rents, and renter household incomes will certainly decrease the quality of this portion of the rental stock. Shilling (2010) found that, in the city of Chicago, net rental revenues are at or below total operating costs for about 74,000 rental units, or about 12.5 percent of the rental stock. Property managers facing stagnant or declining rents often face increasing costs in areas such as property taxes, insurance rates, and energy costs.

Rising energy costs are particularly a problem for the multifamily stock because of the age of the stock. Housing built in the 1990s is about 23 percent more energy efficient than housing built before 1960 and 17 percent more efficient than housing built in the 1960s and 1970s (Brown and Wolfe, 2007). Not much data are available on energy costs in multifamily structures, but the experience with public housing is well documented. Rising energy costs contribute significantly to the operating subsidy shortfalls in public housing. The U.S. Department of Housing and Urban Development (HUD) spends \$4 billion on energy per year, which is more than 10 percent of its operating budget. In 2004, HUD reimbursed public housing authorities \$1.3 billion for utilities, representing 22 percent of total operating expenses (HUD, 2008).

Improving the energy efficiency of the multifamily housing stock presents significant challenges. Much of the weatherization and other public subsidy programs are focused on homeowners and are sometimes difficult to adapt to multifamily structures. In addition, owners and tenants face different incentives making it difficult to align the costs and benefits of investments in energy efficiency. Owners of buildings with individually metered units have little incentive to make investments to improve energy efficiency because most of the savings go to the tenants, not the owners. In buildings where tenants do not pay utilities but control consumption, one study estimated that tenants set thermostats 1 to 3 degrees higher than tenants who pay utilities (Brown and Wolfe, 2007).

Managers of cash-strapped multifamily rental properties are likely to forgo maintenance, which will decrease the quality of the property over time. This filtering down of rental units may provide affordable housing opportunities for low-income households in the intermediate term, but if these conditions persist, units may be lost from the stock because of abandonment by property owners. In markets with rising vacancy rates and declining rents that were overbuilt during the housing boom, the stock is expected to shrink as the market adjusts. Losing viable units because of a frozen credit market or declining incomes, however, raises concern about the long-term availability of affordable rental housing. When the distressed properties are concentrated in low-income neighborhoods that serve some of the nation's poorest citizens, property abandonment can significantly decrease the affordable housing options available to low-income households and add to the blight of these neighborhoods.

## **Federal Response to the Crisis**

The federal policy response to the current crisis has focused almost exclusively on homeownership. The creation of two rounds of homebuyer tax credits and the various loan modification and foreclosure mitigation efforts have received much attention. The bailouts of Freddie Mac, Fannie Mae, commercial banks, investment banks, and insurance companies have focused on cleaning up the subprime mortgage mess.

Renters displaced by foreclosures had no access to resources available to homeowners going through foreclosure and often had to move and find new housing with little notice. Congress enacted the Protecting Tenants at Foreclosure Act of 2009 to provide tenants with at least 90 days to move from a home that has been sold at foreclosure. If the tenant has a bona fide lease in place at time of foreclosure, the lease must be honored unless the new owner will occupy the unit as a primary residence. These tenant protections were set to expire at the end of 2012 but were extended to the end of 2014 in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Current conditions in the rental housing market suggest that foreclosures will continue to rise, which will have a significant adverse effect on renters and rental property owners. The Dodd-Frank Act requires that the Secretary of Housing and Urban Development develop a Multifamily Mortgage Resolution Program that will protect tenants and at-risk multifamily properties by creating sustainable financing, maintaining current levels of subsidy, providing rehabilitation funds, and facilitating the transfer of troubled properties to new owners—all of which will help maintain the affordability of the existing units.<sup>4</sup>

In the near term, existing housing programs could be modified or expanded to address the declining economic status of renters in this downturn and the precarious financial condition of an increasing number of rental properties. The housing voucher program could be expanded to include more eligible households. New vouchers could, for example, target renter households displaced by foreclosures, increasing their ability to find new housing. Vouchers spent on rents for vacant units, as well as those that allow renters to fully meet their rent obligations, could ease the cash flow problems facing many multifamily property owners. Providing vouchers to renters would likely have strong stimulative effects on the economy because low-income households have low savings rates.

Bringing the foreclosed one- to four-unit stock back into the market is a clear priority. Turner (2009) suggested that the Neighborhood Stabilization Program, which received \$2 billion in funding under the ARRA, should be used to provide technical assistance to rental housing providers to convert viable foreclosed ownership stock to rental housing. These conversion efforts should focus on foreclosed units in “opportunity-rich” communities, where few affordable rental housing options exist due to land use restrictions. The LIHTC, the major federal housing production program, could be modified to provide incentives for developers to convert foreclosed stock to viable rental housing. In addition, the LIHTC could be used to encourage investments in the existing multifamily stock to improve energy efficiency or to reverse the disinvestment that may occur because of current market conditions.

The largest issue facing rental housing is the credit crisis and its implications for the multifamily mortgage market. In any consideration of the future of Fannie Mae and Freddie Mac, the needs in the multifamily mortgage market must be considered. The Dodd-Frank Act acknowledged the importance of the GSEs to the multifamily mortgage market by mandating that the Treasury Secretary conduct a study and develop recommendations to end the conservatorship of Fannie Mae and Freddie Mac, including an analysis of the impacts of housing finance reform on the financing of

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<sup>4</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Sec 1481.

rental housing.<sup>5</sup> The GSEs are essentially the only source of multifamily mortgages in the market today; with no signs of other providers on the horizon. Their current importance in the multifamily mortgage market does not mean that Fannie Mae and Freddie Mac must exist in their current form going forward, but rather that the multifamily mortgage market must be considered when the nation's housing finance system is reconstructed. Rebuilding the multifamily part of the housing finance system requires more analysis of the state of the market nationally and in local markets. The current dearth of publicly available data on the market could be mitigated by making the multifamily portfolio data from Freddie Mac and Fannie Mae available to researchers and policy-makers. Given the level of taxpayer support of Fannie Mae and Freddie Mac, it seems reasonable that taxpayers benefit from the lessons learned from both firms' experiences in the multifamily mortgage market.

## Rethinking Federal Housing Policy

The housing market crash has brought decades of federal housing policy into sharp focus. A critical examination of the role of government in the housing market is essential. It is time to rethink government intervention in the housing market by going back to first principles. Although promoting homeownership has been the centerpiece of federal housing policy for six decades, the current crisis clearly illustrates that homeownership is not for everyone. Owning a home is a significant investment that can be risky. Homeowners, like investors in any other market, need to have the resources to weather downturns in the market. It is crucial to target scarce federal resources to efficiently achieve policy objectives. In this reassessment of federal policy, all subsidies, whether direct cash subsidies or subsidies provided via the tax code, should be part of the discussion. What are the federal policy goals? How should scarce subsidies be allocated between rental housing and homeownership?

The mortgage interest deduction is the major subsidy to homeownership that, according to the Congressional Budget Office (CBO), resulted in a revenue loss of \$80 billion in 2009 (CBO, 2009).<sup>6</sup> In addition, the subsidy to the single-family mortgage market provided by the GSEs mounts as the bailout continues. In his article in this issue of *Cityscape*, Glaeser (2011) argues that it is time to rethink the homeownership subsidies. He argues that the results of the housing crash challenge the standard assumption that homeownership is a path to wealth accumulation, acknowledging that it is an investment that carries substantial risk. He also argues that the subsidies are regressive, because a disproportionate share of the benefits go to the wealthiest Americans and that the subsidies encourage the purchase of larger homes, which has resulted in increases in energy consumption, lot sizes, sprawl, and commuting times.

Another traditional argument for favoring homeownership is that homeowners have a stake in their local communities and therefore have an incentive to invest in social capital. DiPasquale and Glaeser (1999) provided evidence that homeownership encourages investments in social capital.

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<sup>5</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Sec 1074 (F).

<sup>6</sup> CBO estimates the revenue loss from the deduction of state and local property taxes at \$16 billion and the revenue loss from the capital gains exclusion at another \$16 billion.

Homeownership increases memberships in nonprofit organizations, voting in local elections, the ability to identify his or her U.S. Representative or school board head, and a willingness to help to solve local problems. They also found, however, that a large portion of the effect of homeownership on increased investments in social capital is due to lower mobility rates among homeowners, which results in longer tenure in the community.

Sinai and Souleles (2005) argued that homeownership is a hedge against rent risk. Most owners (those with the very common 30-year fixed-rate mortgage) face constant mortgage payments while rents adjust annually. Could the community benefits often attributed to homeownership be achieved in rental housing with longer term leases? The increased mobility of renters with short-term leases provides substantial benefits in terms of pursuing economic opportunities. However, for households at a stage in life where increasing the length of time in one community is preferred (for example, a family with kids in school), a stable rental situation could be very attractive. Longer rental contracts would also benefit landlords by decreasing the costs of frequent tenant turnover.

Why have long-term leases not become a readily available option in the marketplace if there are potential benefits to both the tenant and the landlord? Although the concept is very simple, the details are not. What would be a reasonable penalty for breaking a lease before the end of the term? Under what conditions could the renter break the lease with no penalty? What happens if unit condition changes during the term of the lease? How much would a landlord save with less frequent turnover? Both the tenant and the owner would need to fully understand the risks and rewards of the longer term lease. Federal policy could play a very important (and inexpensive) role in exploring the viability of longer term leases by setting up a pilot program to experiment with standards for such leases and providing incentives for rental housing providers to experiment with longer term leases as a tool for building stable, long-term rental communities. Federal policy provided just this type of leadership in developing mortgage standards that led to the widespread acceptance of the 30-year fixed payment mortgage, including standards for prepayment penalties.

The basic rationale for federal involvement in rental housing has centered on the goal of ensuring a safe and affordable living environment for poor households, the elderly, and the disabled. Assisting these vulnerable populations and ensuring the availability of housing with the necessary services required by special needs populations, are worthy endeavors. A fundamental difference between the subsidies for homeownership and those for rental housing is that homeownership subsidies are entitlements while subsidies for renters are discretionary. The mortgage interest deduction is available to anyone who files a tax return and decides to take the deduction. Any homebuyer who qualifies for a Fannie Mae or Freddie Mac conforming loan receives the benefit of a lower interest rate because of the implicit subsidy to the GSEs. No eligibility criteria exist, which means that the subsidies to homeowners are provided regardless of income or wealth. Recipients of rental housing subsidies must qualify by having income below program limits. In addition, rental assistance programs are subject to budget limitations, which means that not all eligible households receive subsidy. Currently, only about 23 percent of those eligible for rental assistance in the United States actually receive that assistance (Turner, 2009).

The largest rental housing subsidy program is the Housing Choice Voucher; in 2009, CBO estimates that \$16 billion was spent on vouchers. Public housing is the second largest program, costing

taxpayers \$11 billion in 2009 for operating expenses, capital improvements, and limited new construction, largely under HOPE VI. The LIHTC resulted in a revenue loss of about \$6 billion.

Vouchers have become the centerpiece of federal rental housing policy during the past three decades, offering flexibility to recipients in choosing housing and neighborhoods. Vouchers can be short term or longer term, and the program can grow and contract as the needs of the target population change.

Taxpayers have made substantial investments in public housing and in privately owned subsidized stock during the past six decades. The nation's affordable housing stock is a valuable, long-term, national asset that serves working low-income families and the poorest members of U.S. society. Housing units are long-term assets that require significant investments over time. At this point, a substantial portion of resources available for rental housing is committed to maintaining the existing stocks of units created by programs that are no longer active (DiPasquale, Fricke, Garcia-Diaz, 2003). Allocating resources to build housing assets in particular locations is a long-term commitment not easily undone. Such commitments make it difficult to reallocate resources to address changes in the housing market like those experienced in the current housing crisis. Future long-term commitments to building housing assets should be carefully considered with a critical assessment of their long-term value.

With rental vacancy rates near historic highs, downward pressure on rents and the growing foreclosed housing stock, subsidized new construction is difficult to justify in most markets around the country. Yet, new construction continues under the LIHTC program. The program could be modified to limit new construction to only markets where a demonstrated need for new units exists. Additional modification could be made to give priority to projects that would repurpose the foreclosed stock or those that would provide investment dollars to preserve at risk rental properties. Tax credits and other subsidies are allocated on the basis of population rather than market conditions. Although the political advantages of allocation by state based on population are clear, such allocations can result in scarce subsidy dollars going to markets that have little need while markets where conditions are much worse, have too few resources. Allocating tax credits (or other federal funding) based on market conditions and needs rather than on population would result in better outcomes.

With the current crisis, a consensus is emerging that homeownership is not for everyone. This consensus provides an opportunity to strengthen both the rental and owner-occupied housing markets. Putting rental and owner-occupied housing on a level playing field will broaden the housing choices available to all households. Ending the preferred status of homeownership will give households a clear choice in selecting the tenure that best matches their financial situation and their stage in life. Rental housing could be viewed more broadly as long-term housing rather than a stepping stone to homeownership.

As federal housing policy is revamped, all direct subsidies and subsidies for housing provided via the tax code must be reconsidered. Scarce subsidy dollars should be targeted to the neediest in our country. The full costs and risks to taxpayers of any long-term commitments whether for building subsidized housing units or the new housing finance system must be assessed before making such commitments.

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## Author

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