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IN FOCUS

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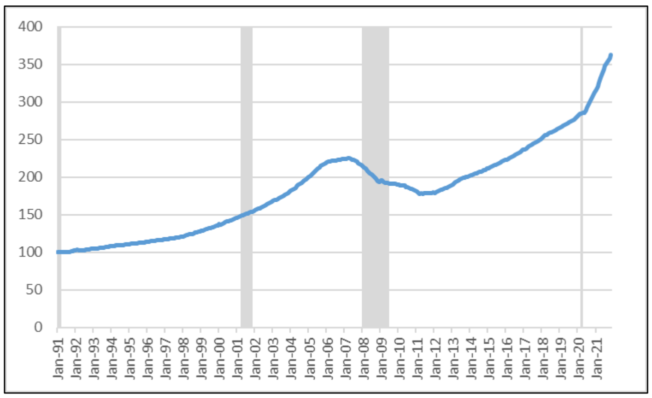
High Home Prices: Contributing Factors and Policy Considerations

Introduction

Home prices have been rising over the past decade, with the rise accelerating during the COVID-19 pandemic (see **Figure 1**). Policymakers and the public have expressed concern over the impact high home prices may have on individuals, society, and the economy. This In Focus reviews a number of factors that have contributed to high home prices and discusses selected policy considerations.

Figure 1. Home Prices

January 1991-November 2021



Source: FHFA Purchase Only House Price Index.

Notes: Index January 1991=100. Gray bars indicate recessions. The March-April 2020 recession was triggered by the onset of COVID-19.

Contributing Factors

There are several potential factors contributing to the rise in home prices, both over the past decade and since the start of the pandemic. But at the heart of the rise in home prices is the interaction between supply and demand: There are more people who want to buy homes than there are homes for sale. As a result, prices have increased.

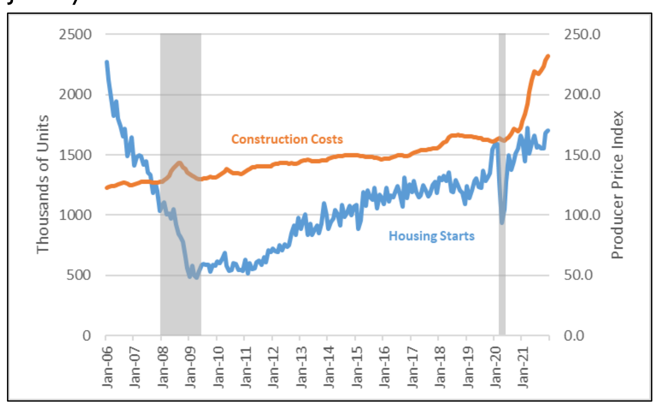
The upward trend in home prices over the last decade started in mid- to late 2011 partly as demand rose with an improvement in household incomes and balance sheets (and the economy) after the 2007-2009 financial crisis and housing bubble burst. Accompanying the recovery was the start of a general downward trend in mortgage interest rates that has been attributed to a number of factors, including Federal Reserve (Fed) policy, slower than expected economic growth following the financial crisis, a global savings glut, and aging demographics. Mortgage rates continued to hover around historic lows into 2022, supporting home-buying demand.

More recently, changes in household behavior during the pandemic have further pushed up demand. In the initial months of the pandemic, the personal saving rate rose significantly, leaving some potential homebuyers better positioned to purchase homes. The pandemic also changed the preferences of some households for amenities correlated with homeownership, such as more square footage and larger yards. The National Association of Realtors (NAR) reported that in 2021 existing home sales reached their highest level since 2006.

On the supply side, even before the pandemic, the inventory of new and existing homes had been relatively low compared to levels in the late 1990s and early 2000s. The low home inventory was drawn down further during the pandemic. For example, in the second half of 2020, the inventory of new homes was equivalent to 3.5 months of supply at the then-current sales pace, matching the all-time low set in August 2003. The NAR's latest data show that the inventory of existing homes reached an all-time low equal to 1.8 months of supply in December 2021. A six- to seven-months' supply of homes is typically thought to indicate a balanced housing market.

Figure 2. Housing Starts and Construction Costs

January 2006-December 2021



Source: Census Bureau and HUD, New Privately Owned Housing Units Started; BLS, Producer Price Index by Commodity: Special Indexes: Construction Materials.

Notes: Construction Cost Index January 2020=100. Gray bars indicate recessions.

High home prices and historically low home inventories should be encouraging builders to ramp-up construction. Housing starts have generally been trending upward after dropping precipitously at the start of the pandemic. However, the cost of construction has also risen and at a faster rate than starts (see **Figure 2**). The increase in construction costs is likely due to supply chain impacts on the availability of materials as well as labor shortages. Some of the pressure on home prices should start to be alleviated as supply chain bottlenecks and labor shortages are resolved, lowering construction costs, and as supply is added.

Selected Policy Considerations

The Two Sides to Higher Home Prices

Economists view prices as market signals that help to direct resources to their most productive use. Some policies to address high prices could distort these signals, reducing economic efficiency. But price changes can also have distributional effects. Higher home prices impact those who desire to own a home differently from current homeowners and homebuilders. As a result, policies that are intended to address rising home prices will impact buyers and owners differently.

On the one hand, high home prices decrease homeownership affordability for potential buyers. Some buyers may still be able to purchase their preferred homes, while other buyers may have to compromise on home size, amenities, quality, and location. Still others may choose to continue renting either to wait for home prices to come down or because they were effectively priced out of their desired markets. High home prices could decrease housing affordability in the short term for households that continue to rent to the extent that home prices and rents are correlated.

On the other hand, current homeowners generally welcome higher home prices, aside from potentially higher property taxes. As home prices increase, homeowners experience an increase in their home equity (home price minus mortgage) and therefore an increase in their overall net worth. Home equity can be borrowed against to finance home improvements, unexpected emergencies, health care expenses, a child's education, and personal consumption. Some have argued that the benefits from homeownership provide a rationale for government ensuring homeownership is affordable. For more information, see CRS In Focus IF11305, *Why Subsidize Homeownership? A Review of the Rationales*, by Mark P. Keightley.

Housing Supply Increases Take Time

A logical step to reduce home prices is to increase the supply of housing. As mentioned previously, high home prices act as a market signal to direct developers to supply more housing. In addition, production-based (supply-side) policies that subsidize the cost of construction could encourage more development. One current policy proposal intended to encourage the development of affordable homes for ownership in certain targeted areas is the Neighborhood Homes Investment Act (NHIA), which is included in the Build Back Better Act (H.R. 5376). For more information about the NHIA, see CRS In Focus IF11884, *Neighborhood Homes Investment Act: Overview and Policy Considerations*, by Mark P. Keightley.

Increases in the housing supply take time, with or without government encouragement, given the nature of construction. The U.S. Census Bureau's Survey of Construction shows that it took an average of 8.8 months to construct a single family home in 2020 from building authorization to completion. The length for multifamily construction was 17.4 months and increased with the number of units and varied across geographic regions. These figures do not include the time needed to locate a building site or design and plan construction and may be understating current completion times given labor shortages.

Demand-Side Subsidies and Home Prices

One approach to making home prices more affordable is to provide financial assistance to potential buyers and current owners, often categorized as demand-side subsidization. Examples include a first-time homebuyer tax credit, the mortgage interest deduction, and federally insured low down payment mortgages (e.g., FHA loans). Demand-side subsidies can help target the issues at the root of affordability: incomes that are too low relative to housing costs and down payment requirements that are too high. However, demand-side subsidies can contribute to home price pressures, negating the intent of the policy. This effect could be greater in the short term, as supply takes time to adjust, and in tighter housing markets.

Impact of Local Laws and Policies

Local laws and policies, particularly zoning and land-use restrictions, can be impediments to expanding the supply of housing. For example, local zoning and land-use policies determine, among other things, whether private land may be developed for residential or commercial use; the type of residential property that may be constructed (single family, multifamily, manufactured); and the number of properties or units allowed per a given land area. Further, homeowner association bylaws of private subdivisions may restrict the types of modifications that residents can make to their properties and how many people may occupy a property.

There are current federal grant programs (e.g., Community Development Block Grant) that contain zoning and land-use *reporting* requirements, but there are no federal programs that attach a requirement that local zoning and land-use policies be changed. Policymakers could attempt to require that federal financial assistance be conditional on modifying local zoning and land-use policies, but this may raise legal issues. Alternatively, localities could be required to consider certain policies as a condition of receiving financial assistance. Flexible financial assistance could be provided to localities to plan and implement certain zoning and land-use changes.

Federal Reserve Policy and Home Prices

The Fed's statutory mandate is to conduct its monetary policy to promote maximum employment and stable prices. Monetary policy, among other factors, influences mortgage rates, which, in turn, influence home-buying demand. The Fed does not take home prices (or other asset prices) into account when setting monetary policy and therefore may contribute to high home prices via lower mortgage rates when the demand for housing is already high. Some have argued that the Fed should consider the effect of monetary policy on home prices and asset prices more generally.

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