

used to write and make speeches about all the ways in which our society was messing itself up, and how it could all be improved, and in his case the things that he talked about were fairly obvious and straightforward, and his conclusions were equally--what shall we say--visionary and utopian as mine. I don't want any of you to think that I really believe that it is politically likely that we are going to turn about 180 degrees in our tax treatment of housing, but I do feel that an honest and clear economic appraisal of the system that we have would reveal tremendous deficiencies, which have the effect of having far too much housing--particularly in the middle and higher income brackets. In my own view there is no sound economic or other justification for this kind of treatment.

Regulation Q: The Money Markets and Housing—I

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The critic of controls who is persuaded that one control begets another certainly finds supporting evidence in the history of regulation of deposit rates. Although many years passed before increased market rates and the prohibition of interest payment on demand deposits induced a sufficiently large substitution of time for demand deposits to make the original Regulation Q rates into a binding constraint, not many additional years later we find a new and very complex set of controls on both the assets and liabilities of banks and non-bank financial institutions. Supplementing the direct control of commercial bank demand and time deposit interest rates, there is now a regulated spectrum of rates for liabilities classified by age, maturity, and type of institution and a companion set of reserve requirement ratios and borrowing arrangements that would take more than my allotted time to describe fully. That the present regulations are not regarded as satisfactory to those who believe regulations are useful quickly becomes clear to any reader of the financial press. Proposals for selective controls on assets compete for space with expressions of concern about the unregulated Euro-dollar market and explanations of new or substitute regulations.

There is not much that needs to be said about the subject of this session, Regulation Q ceilings on interest rates paid to small savers. It is easy to point out that the regulations cannot be defended on grounds of equity, but doing so comes close to tilting with a windmill, since I don't know anyone who argues the contrary case. The usual argument for ceilings is that because small savers are less responsive to changes in interest rates, the government can "protect"

the institutions holding their savings deposits and, at the same time, encourage home building. This is an attempt to justify inequity by pointing to some alleged improvement in welfare that more than compensates for the welfare loss from a reduction in the interest paid to small savers.

Putting the argument for Regulation Q on this basis makes any resolution of the issues hopeless. More importantly, treating the issue as a problem of competing equity claims covers up the economic issues where analysis and evidence can be brought to bear.

Arguments for Selective Controls on Deposit Rates

There are two main economic arguments for selective controls on deposit rates. First, the controls are said to protect one or another institution or group of institutions from failing and/or protect the depositors in the institution from losses. Second, the controls are defended as a means of increasing the supply of mortgages and, therefore, the supply and stock of houses.

There is an obvious flaw in the first argument. The effect of the controls is to force the more knowledgeable, more skilled, or better informed to rearrange their assets and/or liabilities so as to avoid the controls whenever it is profitable to do so. The holders of small savings accounts do not adjust their balances as much in percentage terms as the holders of large CD's. Regulation Q ceilings produced quarterly average annualized rates of change ranging from +100 percent to -100 percent for holders of large CD's and +18 percent to -6 percent for holders of small savings accounts. But the financial structure is not strengthened and the savings institutions are not "protected" by regulations that encourage borrowers or lenders to transact their business in newly formed markets using unfamiliar or less familiar instruments. Yet, few would deny that this has been not only a principal result of control policies for both large and small borrowers but also a main reason for the spread of controls.

Cost of Recent Policies

Recent events suggest some of the costs of recent policies. The financial position of various borrowers and lenders was strained to a point where some went bankrupt. Others incurred relatively large costs of developing new instruments in new credit markets or

learning about unfamiliar but previously existing arrangements. Since these adjustments involve the services of highly skilled professionals, much of the cost is social as well as private. The resources used to circumvent controls are, from the standpoint of society, wasted resources. There are only a few benefits to offset against the social costs of organizing markets and spreading information about the products that are produced and sold in various markets. The recent expansion and subsequent shrinking of the Euro-dollar market was not costless to the societies involved. The same can be said of the expansion of the commercial paper market. Nor is it socially desirable to force these changes, even if some owners of small and large savings or time deposits found it privately profitable to pay these costs so as to avoid Regulation Q. Few would now deny that the expansion and contraction of alternative markets, and other similar shifts in the allocation of financial assets, were the main results achieved by Regulation Q in recent years.

Since I regard the net social cost of controls as a main issue, I want to devote most of my time to what I believe is the main argument for ceilings—ceilings help to produce more housing. I will argue that the alleged social benefits are, for the most part, illusory and that the illusion itself is a consequence of using incorrect economic arguments to defend inappropriate economic policies. These questions are somewhat broader than the narrower question about Regulation Q that I was asked to discuss, but evidence that the controls do not accomplish their purpose may contribute more to the discussion than concentration on the narrow topic.

Selective Controls and Housing

The main defense of Regulation Q and other selective controls is that they assist the housing industry by increasing the supply of mortgages. In the words of two knowledgeable observers,¹ "No matter how housing problems are defined, credit has almost invariably been singled out as the key to the solution." I believe that this statement is wrong, that our housing policy rests on this misconception, and it is the misconception and not the failures of lenders to offer mortgages that explains the failure of the housing stock to expand at a rate similar to the rate of expansion of other real durables or other consumer goods.

¹Leo Grebler and Sherman Maisel, "Determinants of Residential Construction: A Review of Present Knowledge," *Impact of Monetary Policy*, Prentice-Hall, 1963.

Even at the first glance the assertion that credit is the main resource required to increase the stock of housing is peculiar economics. How or why does an increase in the amount of mortgage credit, offered at a given mortgage rate, increase the number of houses built? The former is a nominal amount--the number of dollars that lenders are willing to pay to acquire pieces of financial paper called home mortgages. The latter is a real quantity denominated in units and representing square feet of space enclosed by brick and mortar with plastered walls, dishwashers and garbage disposals. One depends upon the portfolio decisions of lenders; the other results from the allocation of real resources. It is by no means clear that financial decisions change the use of real resources. Most often economists do not regard money or credit as a factor of production, much less the principal factor of production, in the sense required by many discussions of housing. There must be something very special about housing that makes the binding constraint a financial resource, rather than the real resources required to produce other products.

To structure the problems, let me introduce a simple framework that captures some essential features of the housing industry. I use the framework to generate some predictions about the effects of subsidies and selective controls that encourage lenders to increase the supply of mortgages and buyers to increase expenditure on housing. Then I compare the predictions to the events that have occurred.

The Real Factors of Production for Housing

The housing industry uses three factors of production. One, labor, is provided by a monopolist, or more correctly, a group of cooperating monopolists who restrict both the number of union members and the number of licensed journeymen so as to raise the real wages of the members of the monopoly unions. The principal threat to the monopoly power of the unions comes from the existence of substitutes in the form of (1) items produced away from the building site using more capital-intensive processes and (2) nonunion laborers--many of whom would be willing to join the union if restrictions on entry were lifted. Nonunion laborers produce many of the single-family homes built in suburban areas.

The unions long ago recognized the threat posed by substitution of the second factor of production, capital, for labor and were able to get state and local governments to pass laws making it illegal to

use many of the substitutes. Since many of the restrictions on substitution are now part of the building codes, the restrictions acquire the force of law. Where this is the case, the union is able to limit the substitution of capital for labor in the nonunion sector as well as in the union sector. In this way the unions reduce builders' opportunities to substitute capital for labor in construction.

The third factor of production is land, a relatively poor substitute for labor in production. By building in suburban areas, however, builders are able to reduce the per acre cost of land--the per acre cost of raw land--and the unit cost of labor. The reduction in the unit cost of labor is obtained by using nonunion labor, thereby avoiding those union restrictions that do not have the force of law.

Congress became convinced that increased housing production and ownership were desirable socially and encouraged various administrations to develop programs to expand the housing stock. The experts responsible for developing these programs appear to have reasoned as follows: Many potential buyers of houses are deterred by their inability to finance costly durable purchases. The way to encourage production is to develop an industry with the principal purpose of making mortgage loans. The housing industry will expand to provide for the increased demand and, in this way, the housing stock will increase in amount and perhaps in quality.

Throughout, this argument ignores the effect of the monopoly unions. In the presence of the monopoly unions one expected effect of the numerous government programs to encourage home building is an increase in the wage of the workers in the building trades. If the government programs increase the power of the unions sufficiently, the main effect of subsidizing expenditure on housing is to raise the relative price of housing and the relative wage of workers in the building trades.

Both of these results are confirmed by the data for the postwar years. From 1950 to 1969, the deflator for nonresidential structures increased by 90 percent and the deflator for residential structures increased by 67 percent, both substantially greater increases than the 52 percent increase in the price deflator for total private expenditures--that is, for GNP minus the compensation of total government employees--or the deflator for any of the components of private expenditure. During the same period 1950-1969 hourly wages in contract construction rose to 260 percent of their 1950 base, that

is, by 2.6 times, while wages in manufacturing rose by 220 percent. During the same period the number of houses built fell, as the price of houses rose relative to other prices.

These results are, as I said, partly to be expected if the government encourages expenditures and does little or nothing to limit the monopoly power of the building trades unions or eliminate the laws restricting the substitution of capital for labor. Encouragement of the savings and loan industry, restrictions on their portfolios, on the rates of interest that they pay depositors—restrictions including but not limited to Regulation Q—schemes to supplement mortgage payments, and tax benefits to homeowners are only a few of the better known subsidies, prohibitions, and restrictions designed to increase expenditures on housing. They have succeeded. Expenditure has increased both relatively and absolutely. But housing starts and houses built have both declined.

Monopoly power is not sufficient to explain both the decline in housing starts and the rise in price. Increased degree of monopoly or some other factor shifting the supply curve to the left must be invoked to explain the combination of declining real output and the rising relative and money prices of housing.

Nor is the decline in output small. New housing starts in 1969 are only 76 percent of new housing starts in 1950. One may argue that 1950 and 1969 are exceptional years, since housing starts in 1950 were at an all-time high of nearly 1.9 million units and housing starts in 1969 were depressed by the particular policies being pursued in that year. But no other industry has received so much attention and so much encouragement to expansion yet produces less real output after two decades of “encouragement” and subsidy. Moreover, we can ignore the peak year, 1950, and compare the most recent four years, 1966-69, to the four years 1951-54. The qualitative result is the same; output for the latter years is 15 percent *smaller* in real terms than output 15 years earlier.

Other data give similar results. The nominal amount of housing—the market value of new houses privately built—has increased by 50 percent during a period in which the price of residential structures rose 67 percent. During two decades in which production of consumer durables doubled and production of other nondurables more than doubled, the production of housing declined. Doubtless some allowance must be made for change in the quality,

size and mix of housing, but these qualifications seem insufficient to me to explain the 15 to 25 percent reduction in the number of units produced. Table 1 presents these data.

TABLE 1

NUMBER AND VALUE OF HOUSING UNITS PRODUCED
AND WAGES IN CONSTRUCTION AND MANUFACTURING
(1969 AS A PERCENTAGE OF 1950)

YEARS	Number of Housing Units	Value of New Units Privately Produced	Wages in Contract Construction	Wages in Total Manufacturing
1969/1950	76%	152%	257%	221%
<u>1966-69</u> 1951-54	85%	150%	195%	175%

Source: Economic Report of the President, January 1970.

Reasons for the Failure

A very basic misconception is responsible for the failure of the housing program—selective controls and subsidies—to produce more houses. The misconception is that permanent increases in output can be pulled out by increasing expenditures—that an increase in the dollars of credit made available to finance expenditure on housing produces a proportional increase in real output, i.e. in the number of houses built. The base of this reasoning is the familiar argument that increased nominal expenditure stimulates production of real goods and services. The result of the policies based on this conception, as the data I cited suggest, has been an increase in the relative price of housing and a reduction in the number of houses built.

When we look at the time series more closely, in Table 2, we find that, during the period 1950-1969, expenditures for residential structures rose 11 percent more than total consumption expenditures. In the 1950's and early 1960's expenditures for residential

structures increased at about the same rate as total consumption expenditures. After 1962, expenditures for residential structures increased much more than total consumption expenditures, while the number of housing units built remained below the average for the 1950's. One reason, and I believe it is a main reason, is the combination of government policy and monopoly union power. The government's program, aimed at increasing housing output by increasing housing expenditures, increased the value of the union monopoly and the power of the building trades unions. The building unions were able to use their market power to increase relative wages; wages of construction workers rose relative to the wages of other unionized workers. The data show that the ratio of wages in construction to wages in total manufacturing, after remaining relatively unchanged from 1953 to 1959, rose by more than 12 percent in the 1960's.

TABLE 2

HOUSING STARTS, RELATIVE HOUSING EXPENDITURES
AND CONSTRUCTION COSTS

YEAR	Ratio of expenditures for residential structures to total consumer expenditure	New Private Housing Starts (thousands of units)	Ratio of wages in contract construction to wages in manufacturing
1950	.996	1908	1.291
1951	1.000	1420	1.296
1952	1.002	1445	1.290
1953	1.001	1402	1.310
1954	.978	1532	1.340
1955	1.000	1627	1.320
1956	1.025	1325	1.318
1957	1.020	1175	1.320
1958	1.000	1314	1.336
1959	1.018	1495	1.338
1960	1.014	1230	1.360
1961	1.011	1285	1.379
1962	1.017	1439	1.382
1963	1.025	1583	1.385
1964	1.044	1502	1.402
1965	1.052	1451	1.418
1966	1.053	1142	1.430
1967	1.077	1288	1.460
1968	1.095	1484	1.459
1969	1.111	1446	1.491

Policymakers and some economists apparently believe that there are some very special and peculiar features about housing. In most industries the recommended way to increase real output is to shift the supply curve by increasing the quantity and quality of labor and capital inputs, reducing monopoly restrictions and improving techniques of production. In housing most of the programs seek to reduce the cost of mortgage loans or the cost to the purchaser of buying a house.

Increases in the relative wage of the unionized construction workers and in the relative price of housing do not by themselves explain the sizable shift in the supply curve of housing that produced the 15 to 25 percent decline in the number of houses built. Most of the single-family houses are, I believe, built by nonunion laborers who receive less than the monopoly wage and possess much less market power than the unionized workers. Increased wages for the unionized workers are expected to induce a substitution of nonunion workers for union workers in home construction. This has occurred. The problem is now to explain why an increased supply, or at least an unchanged quantity of houses, is not built using more nonunion and less unionized labor. To explain the decline in housing, we must look at some indirect consequences of union power and government policy.

The main sources of the unions' strength in housing are the building codes and regulations. These limit the ability of builders using nonunion labor to substitute capital for labor when wages increase. Consequently, when faced with an increase in total expenditure and in the aggregate demand for labor, builders in the nonunion sector must, to a much greater extent than other producers, either increase wages or lose labor to other industries. In industries other than housing, the effect on profits of increased labor costs resulting from inflationary policies and increased demand for labor can be offset to a much greater extent by substituting capital for labor.

Two main implications follow from this argument. One is that the price of housing rises more than other prices in periods of economic expansion. There is some evidence that this occurs, although I do not want to rely entirely on evidence of this kind because it is difficult to separate the effect of economic expansion on the relative price of housing from the effect of expenditure subsidies and controls that I discussed earlier. The confounding is particularly serious because the

combination of usury laws and controls like Regulation Q do not have a uniform effect. The difference between market clearing rates and the rates paid by those who are able to borrow at savings and loan associations changes as market rates of interest change. Since market rates rise in periods of economic expansion and fall in periods of recession, the effect of fixed ceiling rates and usury laws increases in periods of rising output and prices.

The second implication is that the number of houses built increases following declines in economic activity and declines during periods of rising economic activity, or more simply put, the most expansive periods for housing construction are periods in which other industries reduce the demand for skilled and semi-skilled labor. There are five relative peaks in the housing-start data: 1950, 1955, 1959, 1962-63, and possibly 1968. Each of these years follows a year of recession. In each of the years, the economy was expanding but had not reached full employment.

Conclusion

Let me summarize my argument in a few sentences. Housing like any other product is produced by using inputs of labor and capital. Housing policy is based on the notion that loans and mortgages are the principal scarce factors of production. Acting on this belief, the government attempts to increase expenditure on housing. Expenditure has increased, but the increase has not been accompanied or followed by an increase in the number of houses built. In the past 15 to 20 years, housing starts and completions fell.

Housing is a cyclical industry. It is an expected consequence of the use of policies to slow inflation or to expand output that postponable expenditures for durables are affected more than nondurable consumption. This point is often overlooked. Discussions of housing seem to confuse the postponement of housing that results from increases in market interest rates with the permanent reduction in the stock of housing that would occur if real rates of interest remained permanently higher. The restrictive monetary policies that at first raise market rates of interest ultimately bring about reduction in prices, output and employment and thus lower market interest rates. Temporary reductions in market and mortgage rates of interest encourage expenditure on housing; the temporary increases in measured unemployment add to the supply of labor available to build houses.

To repeat what I said on a similar occasion several years ago, the housing industry is relatively labor-intensive and has a relatively low rate of productivity increase. Given the very large adjustments that mistaken public policies--fiscal and monetary--force on the private sector from time to time, it is hard to think of another industry that can release so many skilled workers at such low social cost. To the extent that regulations like Regulation Q prevent a decline in housing, they transfer the effect of restrictive policies to other, more capital-intensive industries. The social cost of the decline in output is therefore increased by these policies.

The message in this analysis is that the proponents of housing ought to remember that production depends on the use of real resources. Few I think would argue that increased production of autos or butter requires an increase in the amount of credit offered to buyers of cars or cubes at the current market interest rates. The same reasoning applies to housing. If policymakers decide to increase the production of houses, the most useful methods of expanding output are: increase the use of available technology by the industry; expand the input of trained, productive factors; and weaken the monopolies that restrict output. Indeed social policy ought to find some merit in breaking down the monopoly restrictions, whether or not the public desires a higher rate of production of housing.

Policies of keeping real rates of interest low do, of course, encourage purchases of durable assets. To the extent that monetary and fiscal policies keep the real rate of interest lower than it would be in the absence of such policies, monetary and fiscal policies make it less costly for the public to achieve a particular long-term housing goal. This method of encouraging the accumulation of real capital in general, and housing in particular, should not be confused with policies of market interest rate manipulation and regulation or selective controls on particular lenders.