Housing Economics and the Decline of the Middle Class

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INTRODUCTION

"The cultivation and expansion of needs is the antithesis of wisdom. It is also the antithesis of freedom and peace. Every increase of needs tends to increase one's dependence on outside forces over which one cannot have control, and therefore increases existential fear."
Small is Beautiful: Economics as if People Mattered
- E.F. Schumacher, 1973

Much has been written about the decline of the middle class in America. With a growing percentage of the nation's individual net worth collecting in the hands of a few (the top 1 percent controls more than 40%), it stands to reason that millions of average Americans are losing ground.[1] But by studying the size of new single family homes and the number of cars Americans are buying—cars needed to access isolated neighborhoods—one would think that our individual wealth is endless.

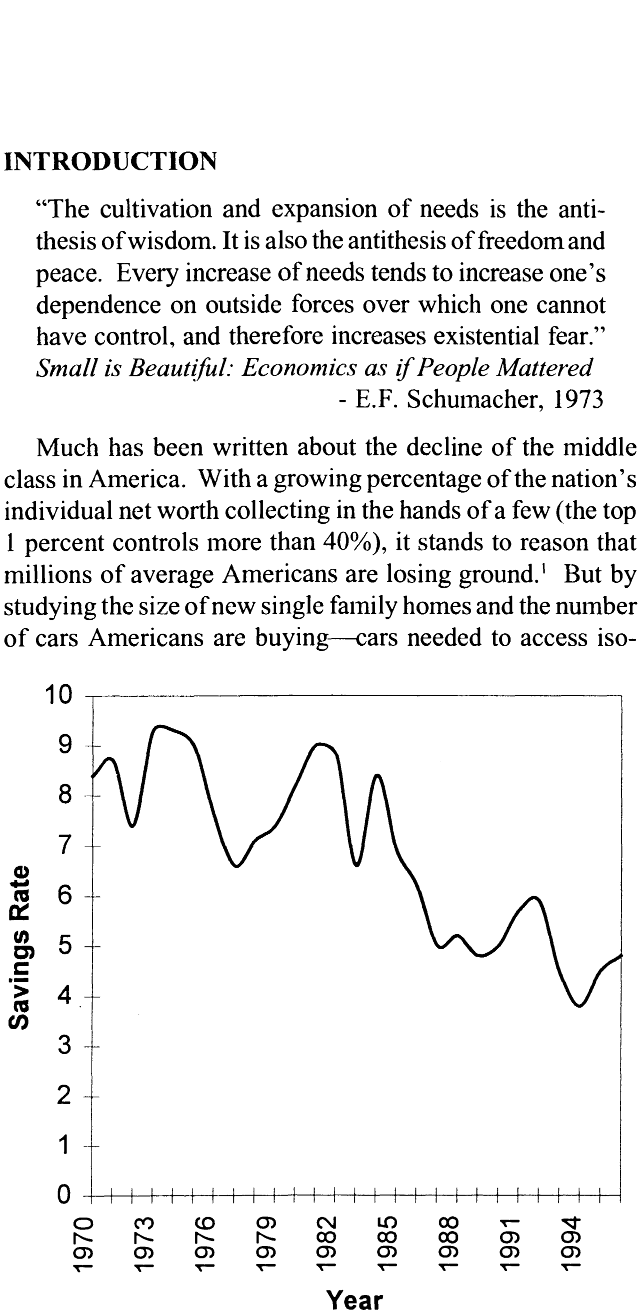

Fig. 1. Personal Savings as a Percentage of Disposable Income
Source: U.S. Department of Commerce, Bureau of Economic Analysis

Instead, much of the middle class is living beyond their means. Despite the rosy short-term economic news of the past several years, declining household income (down 7% since 1989), a 25 year downward trend in the rate of personal saving (Fig. 1), and a record number of personal bankruptcies (1,000,000 expected in 1996), is reason for concern.[2] A long-term economic picture that considers our failing Social Security and Medicare systems and the general decline in personal economic stability suggests an economic crisis is growing on the horizon. To a great extent, this is not surprising, because there is enormous pressure to consume and virtually no education to encourage thrift.

THE AMERICAN FAMILY AND THE GLOBAL ECONOMY

As the economy in the United States becomes increasingly linked to economies around the world, employment opportunities are changing. In a free-market economy, the pursuit of wealth is for many an irresistible force, and fortunes are made with profits, not labor. Today, profits in the United States can by generated by foreign workers and foreign consumers. Low skill manufacturing jobs are moving to cheap labor markets outside the United States emphasizing our need for education to maintain our advantage in management and high skill manufacturing. But for millions of Americans, these high skill jobs will be forever out of reach. Middle class Americans that once earned a good living despite limited education and modest skills will face increased competition for a limited numbers of jobs. The trend toward longer hours and multiple, low wage, jobs with little job security will escalate.[3]

So with diminishing value as cogs in the global capitalistic machine, the promise for a more prosperous life for each new generation of Americans is becoming more difficult to satisfy. This does not mean we cannot all enjoy a high quality of life. It simply means that our measure of success (increasing standards of living) needs to be questioned, because by economic necessity, our lifestyles will change.

THE INFLATION OF NEEDS

We are told that a rising "Standard of Living" is a good thing, a measure of success in the country. But, a higher Standard of Living does not necessarily improve our collective "Quality of Life." By definition, "Standard of Living" is simply the goods and services available to a society or group.[4] We have higher Standards of Living when we have more "stuff." So a higher Standard of Living, stated differently, is really nothing more than a higher "Standard of Consumption." Numerous scholars, Henry David Thoreau and E.F. Schumacher, to name two, have warned us that over-consumption is not "wise." So by simply changing one word, creating two equivalent terms, the goal of higher Standards of Living could be seen as something to be avoided.

Yet, we have an overwhelming variety of products competing for our dollars, and to help us see the need for these products, we are bombarded with nearly sixty billion dollars of advertising every year.[5] The intent of all but a miniscule percentage of these advertising dollars is to cultivate "needs."

When convinced that a new product should become a part of our lives, the cost of the new product or service adds to our cost of living. This increase in one's cost of living does not add to the Consumer Price Index, the governments measure of inflation. It is a self imposed form of inflation, an "Inflation of Needs." This "Inflation of Needs" is the most serious threat to our economic future. With easy credit, lenient penalties for bankruptcy, and an endless supply of consumer temptations, it is difficult to imagine that the savings rate will reach the level needed for self-sufficient retirements.

From a child's first moments of understanding, the saturation of advertising in the United States teaches us to be consumers. Yet, we have virtually no economic education to counter the pressure to consume. A person can pass through twelve years of elementary and high school, four or more years of college for an undergraduate degree and additional years of graduate level university study and never learn one shred of information about our individual roles and responsibilities in a capitalist free-market economy. Consequently, when problems are identified in the function of our economic system, informed debate to make plans for change is virtually impossible. Instead, emotions and narrowly focused self interest dominates and the issues become politicized.

Our focus is short term. We measure "consumer confidence," track monthly interest rates, housing starts, and inflation as indicators of our economic health. Consumption is needed to support life and maintain employment, but the pursuit of ever increasing "Standards of Living" requiring an equivalent "Inflation of Needs" cannot be sustained if the trade off is lower rates of saving.

In the early days of industrialization, innovative efforts led to the development of products and services that truly enhanced quality of life. Electricity led to better lighting, and much needed household appliances such as refrigerators, washing machines, and vacuum cleaners. These products expanded our days into the night as never before and eliminated back-breaking work in the home. Just as computer technology has vastly increased workplace productivity, these early advances in household technology greatly improved productivity and our quality of life at home. But as workplace technology is marketed for use at home, there are minimal productivity gains to be made. Instead these high-tech products are primarily used for entertainment and small measures of added convenience.

Cable and satellite television services, the Internet, and video games—modern high-cost forms of entertainment are replacing conversation, card playing, and reading - "old fashioned" low-cost forms of entertainment. As we incorporate new products and services in our lives, we justify the present economic cost, but what virtually no one recognizes is the long term cost some of these "needs" represent. Over a working lifetime (when savings are accumulated), "needs" that are "needed" every month are particularly expensive. With a conservative average cost of $30 a month for cable television service, a cellular phone, or Internet access, the investment value of the money spent on these services over forty years (age 25-65), using investment averages, would grow to $350,000 each. That is a significant amount of money, but the real savings can be found in our choice of cars. Choosing to drive any vehicle with a total ownership cost of just $100 a month less than you can afford (not hard to do), for forty years, would provide $1,000,000 for retirement.[6] Small but consistent efforts to build savings begun early in one's working life are all that is needed for life long financial security.

But evolutionary psychologist, Timothy Miller's, research of the human trait to "always want a little more," explains our growing consumption related economic problems. In his book, *How to Want What You Have*, he writes, "People spend their lives honestly believing that they have almost enough of whatever they want. Just a little more will put them over the top; then they will be contented forever."[7] We may be programmed to consume by evolution, but that in no way diminishes the need to check our consumption. In fact, based on Dr. Miller's research, we need economic policy that actively discourages consumption to counter our evolutionary tendency to consume. Unfortunately, practically the opposite condition exists. Our tax policies penalize savers and reward consumers. This is particularly true in our purchase of houses and automobiles.

FEDERAL TRANSFERS OF WEALTH

Federal subsidies distort the price of buying a house and driving cars—two of the most expensive family budget items. In a basic concept of a free-market economy, a "good" that has an artificially high or low price is correspondingly either under-consumed or over-consumed. An artificially high or low price in economic language is a "price distortion." When buying a home, a special deduction in the federal tax code distorts the price down. By allowing mortgage interest costs to be subtracted from taxable income, a bigger or more expensive house can be bought than the consumer would be able to otherwise purchase. With this tax deduction, Americans are encouraged to over-consume housing. Along with our evolutionary desire for more, the price distortion for home buying helps explain why the median size new house in the United States has increased by 39.6% in the past 25 years. (Fig. 2)

Similarly, as much as $300 billion of the annual cost of driving is shifted from drivers to society as a whole, thus minimizing the apparent cost of vehicle use.[8] In an example of contrasting attitudes, "Germany, after agreeing to foot $11 billion of the cost of the Persian Gulf war, swiftly enacted a 67 cents-a-gallon increase in gasoline taxes."[9] The German government obviously saw the war as an effort to maintain fuel supplies for automobiles, so the cost was passed directly to German drivers. Here in the United States with gasoline prices among the world's lowest, "consumers (have) shifted out of smaller, high-mileage cars, to larger, family-size cars and trucks, such as minivans and sport utility vehicles."[10] By shifting a major portion of the cost of driving to non-drivers, Americans have developed a distorted dependence on cars.

Subsidies, such as lower tax bills when buying a house, are gifts—a transfer of wealth. The home buyer, can enjoy living in a larger house and is seen as having a higher "Standard of

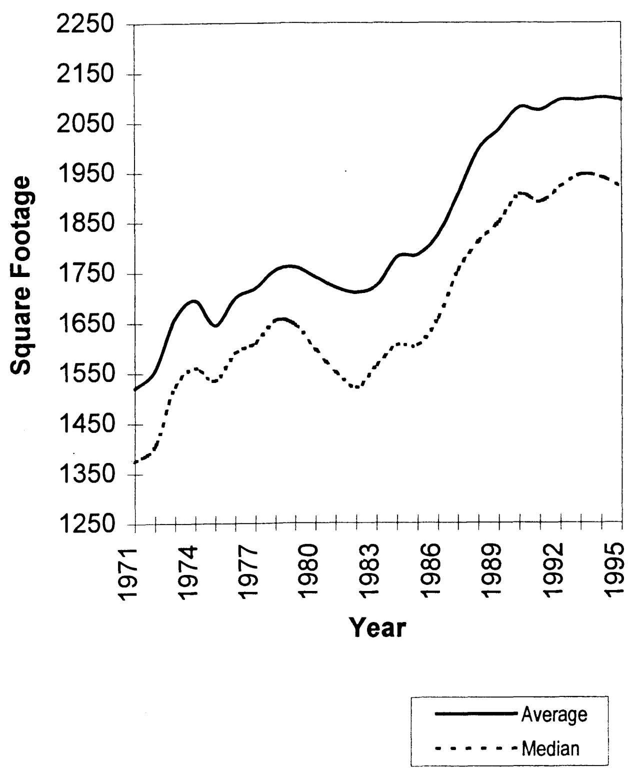

Fig. 2. Average and Median Square Feet of Floor Area in New One-Family Houses Source: U.S. Bureau of the Census. NAHB Economics Department.

Living." By not paying equivalent taxes expected of renters, wealth is transferred from the government to the home buyer. This seems like a great deal for the home buyer, but is this gift from the government justifiable? Well, we must remember that the government only exists to represent our needs, so this transfer of wealth can be thought of as moving money from your savings account (the governments) to your checking account. You have more money in your checking account to spend, but the government has less savings. Since the government doesn't actually have any savings - we are more than 5 trillion dollars in debt - the transfer from the government to home buyers adds 50 billion dollars a year to the budget deficit. And as long as we have a deficit, this fifty-billion dollars a year is added to the national debt.

To follow the money trail another step and to personalize the government's deficit spending, consider this. Big federal budget deficits are politically unpopular. Spending more than one makes is something that most Americans understand as a bad thing and the practice is viewed by voters as irresponsible. So to "disguise the actual size of the federal deficit," government accountants "borrow" money from Social Security.[11] The "borrowed" money is replaced with government bonds, more debt. Excess money paid into Social Security (currently about $60 billion a year) is spent immediately.[12] The idea that there is a Social Security trust fund is a myth. "The government's own actuaries predict the system will be bankrupt by 2030." But in 2014 when Social Security will need to start cashing in those government bonds to pay retiring Baby Boomers, the national deficit will balloon.[13]

Since the Social Security "trust fund" is nothing more than a stack of unfunded government bonds, we can say the $50 billion in lost taxes due to the mortgage interest deduction is coming right out of the governments ability to pay Social Security benefits. The $5 trillion dollars of national debt is incomprehensible, but by thinking of the mortgage subsidy as a direct threat to Social Security solvency, a lot of home buyers might want to take a closer look at the cost versus the benefit.

SUBSIDIZED HOUSING: NOT JUST FOR THE POOR

The home ownership subsidy is hard to justify. It can be argued that neighborhoods and communities are stronger when most houses are owner occupied, so incentives to buy a first home has social value. Unfortunately, the tax deduction for mortgage interest provides little or no help in buying less expensive houses. The subsidy is heavily weighted toward those that need public assistance the least - the wealthy.

Interest on a home mortgage can be listed as an itemized deduction to reduce taxable income. But before a person can reduce their overall tax liability by itemizing, they need to have enough deductible expenses to exceed the Standard Deduction of $4,000 for a single person or $6,700 for a jointly filing married couple. A median income family ($34,076 in 1995) [14], with a $6,700 Standard Deduction, buying a median priced existing home ($112,900 in 1995) [15] might have $12,000 in itemized deductions (about $7,500 in mortgage interest)[16]. With a 15% federal tax rate, they would save about $800 a year in taxes. This $800 in tax savings is for a median income family buying a median priced house, a true entry level home buyer with a lower income would save nothing in taxes.

On the other hand, because the interest on mortgages up to $1 million is allowed, a person taking maximum advantage of the subsidy with a $700,000 luxury home, a $200,000 yacht as a second home, and a $100,000 home equity loan that was used to buy a couple of luxury cars can reduce their tax bill by more than $30,000. This $30,000 subsidy, available for the wealthiest among us, is nearly three times the subsidy that a typical welfare family would receive from State and Federal sources. In Washington State, a single parent with two children receiving welfare benefits (AFDC and food stamps) is limited to $850 per month, or $10,200 per year. [17] Both families benefit from federal subsidy, but the need is vastly different. This subsidy simply makes bigger and more expensive houses more affordable to those that need no help buying an entry level home, and it adds to the growing disparity of wealth in the country (a bad thing) at the expense of increased national debt (another bad thing).

There is another problem with the tax subsidy that distorts the price of a home downward. Bigger houses made more affordable to buy are still more expensive to own. A larger house with construction characteristics equal to a smaller one will be more expensive to heat and cool, maintain, and furnish. Property taxes would also be more expensive. So the "gift" of reduced mortgage cost is offset by increasing spending in other areas, a net loss of potential savings. A higher standard of living today is had at the expense of long term quality of life.

ACCESS TO THE SUBURBS

Another aspect of housing economics that is straining the middle class family budget is the fact that most new homes are built in the suburbs. Autos are often the only transportation option in the suburbs and with subsidies that drive down the cost of driving, suburban life seems less expensive than it really is. And although a family can still find places to live that can be conveniently enjoyed while owning a single automobile, the American landscape, outside city centers, has changed to one that is designed for automobile use. Consequently, the days of one car families are mostly a thing of the past. There are about 22 million more registered vehicles in the United States than licensed drivers. [18]

An interesting relationship between suburban houses and cars can be seen in garage construction. In 1990, 72% of new detached houses had at least a two car garage, and 14% had three car garages—35% in California. [19] The statistics show a direct correlation between increasing garage size and the increase of vehicles per capita. From 1970 to 1994, registered motor vehicles per 1,000 residents in the United States increased from approximately 400 to 761. [20]

The high cost of automobile ownership is actually a bigger problem than the subsidy for home ownership. As mentioned earlier, $100 a month saved by driving a less expensive car can grow to one million dollars in forty years. But, if a family eliminates an average car that gets average use, $5 million could be accumulated. [22]

A couple doesn't need $5 million for retirement, but along the way the savings could pay for college educations, and their daily quality of life could be enhanced by enjoying more meals at restaurants and by attending more cultural events. Higher quality household furnishing could be bought and more frequent and luxurious vacations could be enjoyed. One parent could even work fewer hours to enjoy caring for children. A family could do all of these things and still have enough money left for a comfortable retirement. But as we have allowed our cities and lifestyles to become dependent on automobile use, most American families find themselves paying thousands of dollars per year for every car they own. In 1992, the American Automobile Association (AAA) estimated a cost of $5,320 annually for an average mid-size car. Our use of cars alone leaves little reason to wonder why savings rates have declined and the middle class is shrinking. Our "Inflation of Needs" must be stopped.

A PLAN FOR A BETTER FUTURE

Any mention of increasing taxes to change social behavior brings cries of "social engineering." But likewise, governmental subsidy that creates artificially low prices (under taxation), is also social engineering. With tax policies that reduce the apparent cost of houses and transportation, our behavior has been altered to favor more expensive lifestyles. This practice not only adds to the federal deficit and the trade deficit (imported cars and petroleum), it also undermines personal saving. A low rate of personal saving limits economic growth and global economic competitiveness, but most importantly to individuals, it threatens retirement security. The negative "social engineering" housing and transportation price distortions create have increased short term spending at the expense of economic sustainability.

Eliminating the home mortgage tax subsidy to move back toward more reasonably sized house construction along with true pricing for automobile use would increase the demand for pedestrian friendly mixed-use neighborhood development. Traditional neighborhood design with houses facing the street and one car garages on an alley offer a much richer definition of public and private space, despite increased density. The added density can then support public transit as well as neighborhood shopping and services. This type of development would make one car families possible with little inconvenience and great savings.

These changes are not possible however without an informed public and political commitment. The information most easily available on the issue of home and car buying comes from real estate agents and automobile dealers. To expect these groups to point out the pitfalls of spending beyond one's means is to expect the fox to protect the hen house. Quite the contrary, these special interest groups lobby our political leaders relentlessly to protect the market defying subsidies that enhance their profit potential.

An interdisciplinary education effort is desperately needed to expand the knowledge of our individual places in a society that is largely governed by economics. The pressure to consume is immense, and the argument in favor of thrift is virtually nonexistent. Ultimately, the design of our environment is a critical component of a strong economy. For too many years we have ignored the environment costs and long term personal cost of sprawling development. Members of the design professions must recognize the urgent need for efficient human based design and they must provide the civic leadership to see that it happens.

NOTES

[1] Lester Thurow, "Why Their World Might Crumble" *The New York Times* Magazine, November 19, 1995, p.78.

[2] Ibid.

[3] Ibid.

[4] *The American Heritage Dictionary of the English Language*, Third Edition.

[5] "Total U.S. Ad Spending by Category and Medium, 1995," *The World Almanac and Book of Facts 1997*. Mahwah, New Jersey, 1996, p.297.

[6] Money invested pre-tax and tax-deferred with a 10% average rate of return, 3% inflation and a 28% tax rate.

[7] Robert Wright, "The Evolution of Despair" Time, August 28, 1995, p.57.

[8] James J. MacKenzie, "The Going Rate: What it Really Costs to Drive," World Resources Institute, p.vii.

[9] Pietro S. Nivola and Robert W. Crandall, *The Extra Mile: Rethinking Energy Policy for Automotive Transportation* (The Brookings Institution, Washington, D.C., 1995), p. x.

[10] American Automobile Manufacturers Association, "Fuel Price and Consumer Demand Guide Fuel Economy," Internet Home Page, http:/www.aama.com/briefs/fueleconomy4.html

[11] Karl Borden, "Dismantling the Pyramid: The Why and How of Privatizing Social Security," Cato Institute Project On Social Security Privatization, August 14, 1995, p.1.

[12] Ibid.

[13] Ibid.

[14] "Census shows Americans' income up, poverty down," *The Spokesman-Review*, September 27, 1996, p. A14.

[15] "Housing Affordability," *The World Almanac and Book of Facts 1997*. Mahwah, New Jersey, 1996, p.726.

[16] "Home mortgage deduction no longer untouchable," *The Spokesman-Review*, May 28,1995, p.D4.

[17] Interview with Dave Williams, Social Service Supervisor, Department of Social Health Services. Spokane, Washington.

[18] "Selected Motor Vehicle Statistics" p.245 and "Licensed Drivers, by Age" p.247, *The World Almanac and Book of Facts 1997*. Mahwah, New Jersey, 1996.

[19] Philip Langdon, *A Better Place to Live* (The University of Massachusetts Press, Amhurst, MA, 1994.), p.149.

[20] "Selected Motor Vehicle Statistics," *The World Almanac and Book of Facts 1997*. Mahwah, New Jersey, 1996, p.245.

[21] Money invested pre-tax and tax-deferred with a 10% average rate of return, 3% inflation and a 28% tax rate.