

O'Toole, Randal. *American Nightmare: How Government Undermines The Dream of Homeownership*. Washington D.C.: The Cato Institute, 2012.

There are many theories about what triggered the collapse of housing markets in 2008 and the resulting financial and economic fallout. Thomas L. Hogan discusses the most prominent of these in his book review of Jeffrey Friedman's 2010 edited collection *What Caused the Financial Crisis*.¹

In brief, the facts are as follows: the Federal Reserve Bank's easy money policy spawned the subprime mortgage market and consumer euphoria that led to excessive speculation in the housing market. The idea of bundling higher-risk and lower-risk mortgages as investment securities (collateralized debt obligations, or CDOs) and the credit ratings agencies' initially rosy assessments of these instruments encouraged poorly regulated (or overregulated, depending on your view) banks to hold lots of these supposedly safe investments. When credit ratings agencies downgraded CDOs after they proved to be money-losers for investors in 2008, the mixture of low capital-reserve requirements for banks, and the banks' exposure to what turned into junk bonds, left banks scrambling to find collateral to back up loans, leading to a panic on Wall Street and ultimately creating a recession-inducing contraction in the global financial industry, along with the widespread deflation of housing prices and the rise in foreclosures.

These factors have (rightly) claimed much of the attention of scholars and academics. Indeed, there is an ongoing debate over how these forces worked to produce the crisis, and new research indicates that the Fed's easy monetary policy can only explain one-third of the housing crisis. The causes and consequences of the housing and financial crisis are not a settled case.

In addition, others have pointed to the role that various federal agencies and programs have played in the past few decades in encouraging homeownership among the middle class (via the home-mortgage interest-rate deduction), and among higher-risk homebuyers (through the Community Reinvestment Act). These inducements to purchase houses ended up increasing moral hazard in the mortgage market and passed on the financial risks to individuals and society when buyers ended up "underwater" or in default.

¹ Thomas L. Hogan, "Book Review of Jeffrey Friedman, ed., *What Caused the Financial Crisis*," *Reason Papers* 32, no. 2 (October 2012), pp. 222-28. See also Jeffrey Friedman, ed., *What Caused the Financial Crisis* (Philadelphia: University of Pennsylvania Press, 2010).

All of these theories focus largely on the demand side of the housing equation to explain the bubble and its deflation in 2008. They get at the question of what drove consumers and investors to put more of their dollars into housing in the years preceding the crash. Asset bubbles are the result of the interaction of both changes in demand and supply. Randal O’Toole, senior fellow at the Cato Institute, is adamant that the true cause of the housing bubble—technically, many regional bubbles—has been sidestepped with an excessive focus on the drivers of housing demand. His theory: the bubble and the fallout in financial markets would not have happened if it were not for the biggest factor affecting housing supply—state and local growth-management laws that limit housing development: “[W]ithout the policies limiting homeownership, no housing bubble and no financial crisis would have occurred” (p. 4).

American Nightmare makes a vigorous case to the effect that growth management laws are squarely to blame for the housing bubble and the factors that aggravated it. The crux of O’Toole’s analysis is that growth management laws, by limiting where builders can construct homes, have pumped up housing prices in scores of regional housing markets in the U.S. in various waves since the 1960s. Restrictions on building are the cause of bubbling housing markets in California, Florida, Maryland, Nevada,² and Rhode Island. O’Toole is right to focus on the supply-drivers of the housing bubble, and his basic economic insight on how housing supply interacts with housing demand to affect prices is correct as well.

Where housing supply is constrained (due to some factor), it is said to be “inelastic.” That means that a small increase in the demand for housing leads to a large increase in its price. When the bubble bursts, prices fall below what they would have been absent the bubble. And the effects of these constraints on housing supply can create big swings in prices. If the argument were to end here, O’Toole would stand on solid theoretical ground. He bases his claim on empirical work done by economists Edward Glaeser and Joseph Gyourko, who find in a 2002 paper that “government regulation is responsible for high housing costs where they exist.”³ Their study is careful to note that this does not mean that the nation faces an affordable housing crisis, but that in certain areas—New York City and California—“housing prices diverge substantially from the costs of new construction.”⁴ Though not discussed in *American Nightmare*, Glaeser, Gyourko, and Albert Saiz find in a 2008 paper

² O’Toole notes that Nevada’s housing market is constrained by the large amount of federal land that is unavailable for development, as opposed to state and local growth management laws.

³ Edward L. Glaeser and Joseph Gyourko, “The Impact of Zoning on Housing Affordability,” Working Paper 8835, National Bureau of Economic Research, 2002, p. 21.

⁴ *Ibid.*

that in addition to growth-management laws, the limits of natural topography also create inelastic supply in housing. They conclude that these natural constraints are a powerful supply-side factor contributing to volatility in housing prices.⁵

The supply side matters in determining housing prices, and, in fact, may matter a lot. O'Toole also cites economist Raven Saks's 2005 study, which finds that supply constraints have a bigger effect than an equal shock to the demand side and account for a greater share of the price increase during the boom.⁶ The supply side may help to explain the irrational exuberance of consumers and realtors during the mid-2000s, who may have been fueled by the belief that housing can only appreciate in value.

But there is some nuance at work in the academic literature as well. Glaeser et al. also find that markets with highly elastic supply (i.e., with fewer obstacles to building) also experienced price booms during the periods they studied. And it is unclear whether elastic areas experience an even more severe price crash than inelastic areas after the bubble bursts. The reason: fewer building obstacles mean that "places with more elastic housing build more homes in response to the bubble."⁷ The extra homes create a glut in supply, which reduces prices when the bubble is over. But the exact effect of those extra homes on prices is ambiguous. In other words, markets with fewer building restrictions than in places with inelastic housing can also suffer the consequences of a bubble, though the effects in question tend to be shorter in duration.

Unfortunately, in its drive to reduce the housing crisis to a single and simple cause, *American Nightmare* ends up taking a turn for the worse. O'Toole over-extends his supply-side analysis and ends up erring in the opposite direction of those who focus exclusively on a single demand-side theory to explain the entire crisis. O'Toole not only places the forces that affect housing demand in the analytical background, but goes a step further, transforming them into a *consequence* of growth-management laws. In making his case against growth-management laws, O'Toole's supply-side analysis effectively tries to prove too much. He correctly states throughout the book that an asset bubble is built by the interaction of both supply and demand forces. In Chapter 12, "The Housing Bubble," he writes that "strong economic fundamentals, . . . combined with low interest rates and looser lending

⁵ Edward L. Glaeser, Joseph Gyourko and Albert Saiz, "Housing Supply and Housing Bubbles," NBER Working Paper Series, Working Paper 14193, National Bureau of Economic Research, July 2008.

⁶ Raven E. Saks, "Job Creation and Housing Construction: Constraints on Metropolitan Area Employment Growth," Federal Reserve Board of Governors, September 22, 2005.

⁷ Glaeser, Gyourko, and Saiz, "Housing Supply and Housing Bubbles," p. 14.

practices, did push up prices but played less of a role in price increases than growth-management planning” (p. 187).

But then O’Toole asserts that state and local growth-management restrictions explain the very existence and evolution of the housing bubble. All other explanations on the demand side are treated as either incidental, symptomatic, or a consequence of state and local land-use regulations.

In Chapter 13, which takes its title from the book, O’Toole explains “What the Crisis Wasn’t”: “Other factors that have often been cited as the ‘cause’ of the collapse may have contributed to the bubble, but they were not the cause, and preventing them would not have prevented the bubble or much of the pain that resulted when markets collapsed” (p. 218). Specifically, O’Toole states that the bubble was not caused by low-income borrowers, “greedy bankers,” excessive bonuses, deregulation, low interest rates, or too-big-to-fail-banks. He writes, “not only did growth management cause the bubble, but once this bubble began, very few things could have been done to prevent the crisis” (p. 207).

Early in the same chapter, O’Toole zeros in on three different culprits: “The 2008 financial crisis has often been described as complex because there were so many different participants But the real issue of the crisis boils down to three different factors: state and local growth-management planning, the bond-ratings agencies, and banking reserve requirements” (p. 208).

Not only is O’Toole convinced that all explanations of the housing bubble to date are either implausible or unpersuasive, but he engages in a series of counterfactual speculations to argue that were it not for forty-plus years of growth-management laws, many of the federal policies devised to help people buy homes would either not have been created or their effects would have been benign. For example:

- Congress and the Clinton Administration would not have ordered Fannie Mae and Freddie Mac to start buying large amounts of loans to low- and moderate-income buyers. (p. 217)
- If regulation-induced inelastic housing supplies had not caused prices to rapidly increase when the Fed reduced interest rates in 2001, speculators disappointed with the stock market would have been induced to invest in real estate in growth-managed states. (p. 217)
- If housing prices did not collapse with a small contraction in demand, as they did in growth-management states, then large numbers of people would have defaulted on their mortgages and Wall Street’s bond market would not have collapsed. (p. 218)
- If the passage of growth-managed laws in so many states in the 1980s had not completely changed the rules of the housing market,

then the ratings company would not have erred in so many of their bond ratings. (p. 218)

Despite what is ultimately a strained economic analysis of the bubble, *American Nightmare* compensates by providing much insight into the history and development of American housing policy. Indeed, one of O'Toole's gifts is his ability to take what would otherwise be dull material and weave a textured narrative. The first several chapters of *American Nightmare* are a highly readable policy history documenting the rise of government interventions into housing markets as influenced by the often conflicting visions of interest groups and activists. These chapters have several merits worth noting. O'Toole covers much ground in the evolution of housing policy. He marks these different historical phases and the emerging geographic boundaries in terms of economic shifts, migration patterns, policy interventions, and the ever-present undercurrent of class warfare in American social history.

Beginning with the colonial Agrarian period when less than 1 percent of Americans owned their homes, O'Toole notes the rapid institutional changes that occurred in the nineteenth-century Urban era, increasing homeownership for the working classes to the beginnings of the Suburban period in the 1920s. This history continues with an analysis of the various New Deal and post-war federal experiments with housing policy and home finance. These are the decades that spawned many of the contemporary agencies, programs, and subsidies that remain in place today. It is a valuable read for anyone trying to get an overview of American housing policy during the period of the New Deal/Urban Renewal/Great Society experiments.

These early chapters highlight another merit of O'Toole's work, namely, his drive to understand human motives and the incentives behind the policy experiments, market innovations, and migration patterns of ordinary Americans. He has a view of social change worth considering. Through his lens, suburban and urban geographic boundaries can also be understood in terms of a subtle—and at times overtly racist—strain of class warfare in American society: the tension between the middle class desire to be protected from the working classes and the aspiration of the working classes to own their own homes. He produces some interesting evidence.

In late-nineteenth-century America, ethnic groups had higher rates of urban homeownership than did the middle class. A house is a "poor man's bank" in addition to being a home. It is a store of wealth that allows him (or her) to operate a business. In contrast, the middle class favored renting during this period. They had other places to invest their money and wanted to hedge against the neighborhood suddenly changing. Leasing provides mobility.

The middle class, as a general rule, had more options. Some factors that increased homeownership and drove urbanites into new suburbs included the expansion in credit tools, increasingly scarce land in the cities, the automobile, and new manufacturing technologies that required more space for factories. Jobs moved with people. As the middle class moved from urban-renting to

suburban-homeownership, they sought to protect their home values. Entrepreneurial builders provided the means for their customers—protective covenants and deed restrictions that limit what people could do with their land. These private agreements cost nothing to the developer and could be tailored to the buyer. (If you want to raise chickens in your backyard, buy a house with a deed or covenant that permits it.)

However, deeds only applied to new developments. Existing neighborhoods relied on zoning—a local government tool, prone to political manipulation. Zoning, at first a means of protecting property values and placing sewer lines, was “transmogrified” by legal decisions and other forces (p. 131). By the 1960s zoning was another arrow in the quiver of political activists and urban planners seeking to impose economic development or a particular aesthetic vision on neighborhoods. O’Toole promotes private zoning and protective covenants as a policy fix to the abuse of public zoning. But it should be noted that the effect of covenants on home values may be ambiguous. Covenants, like zoning, limit what can be developed. Tastes change. And it may be that a protective covenant locks into place a particular usage of property that is not valued by buyers. The expiration of a covenant may actually increase the value of a parcel of land.

Activists, intellectuals, and social reformers play an interesting role in O’Toole’s analysis. They are, broadly speaking, “the elite” and their cry may be summed up as, “helping to ensure the poor have decent housing so they don’t move next door” (p. 50). But O’Toole is careful to distinguish among them. There are the “housers” who seek to improve living conditions for the working class. Their efforts begin with the Progressive-era tenement reforms inspired by the writings and photojournalism of Jacob Riis of New York City’s slums. The more unlikeable of the lot in *American Nightmare* are the “utopians” and intellectuals who view suburbia as emblematic of any number of American social, cultural, or aesthetic defects. Here O’Toole singles out the influence of the architect Le Corbusier on the failed futuristic urbanism of the 1960s and 1970s that led city planners to construct bleak high-rise cellblock cement towers. He also has little use for detached social critiques of suburbia, including Robert Putnam’s *Bowling Alone* and Kenneth Jackson’s *Crabgrass Frontier*.⁸

O’Toole’s insights into American social and policy history at times recall the theory developed by Sanford Ikeda in his book *The Dynamics of the Mixed Economy*.⁹ One strong theme that emerges from *American Nightmare* seems to exemplify Ikeda’s theory: A policy intervention can often lead to an

⁸ Robert Putnam, *Bowling Alone: The Collapse and Revival of American Community* (New York: Simon & Schuster, 2000); Kenneth Jackson, *Crabgrass Frontier: The Suburbanization of the United States* (New York: Oxford University Press, 1985).

⁹ Sanford Ikeda, *The Dynamics of the Mixed Economy: Toward a Theory of Interventionism* (London: Routledge, 1997).

outcome that differs from the original intent of the policy. This leads the government later to undertake a “corrective” action to fix the effects of the first, leading to greater distortions. This can go on for awhile, until the effects are yet more distorted, provoking a crisis at which point policymakers must make a radical move: toward greater or drastically less intervention. It would seem that the response to the housing crisis to date has been toward greater intervention in the form of financial and lending regulations, and bank and homeowner bailouts.

American Nightmare has identified just such a complex problem. The conflicting goals of elites to limit urban sprawl with local land-use laws, while providing access to affordable housing via federal subsidies and regulations, are identified by O’Toole as two clashing forces of governmental interference. Where it succeeds, *American Nightmare* is a spirited policy critique of the impossibility of central planning and the role human behavior and ideology play in shaping the contours of American neighborhoods.

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