Homeowning, Social Outcomes, Tenure Choice, and U.S. Housing Policy

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For nearly two centuries, American policymakers have extolled the virtues of homeownership.[1] These policymakers have suggested that owning a home produces better citizens and better communities and therefore a better society.

Yet only recently have researchers attempted to determine whether tenure per se influences outcome and, if so, the size of that influence. If homeowning produces positive social benefits, it makes sense to give people an incentive to become homeowners. That said, from a policy standpoint, it only makes sense to provide incentives to those who otherwise would not become homeowners. Giving homeowning subsidies to those who would be owners even in the absence of such subsidies leads to neither economically efficient nor socially desirable outcomes.

The purpose of this article is to look briefly at links between policies and outcomes. It begins by reviewing briefly the literature on the influence of tenure choice on various social outcomes, followed by a brief discussion of tenure choice itself: a description of why people choose to be owners or renters. Finally, it looks at policies that are designed to enhance the ability of people to become homeowners. The views expressed here are completely personal.

Tenure Choice and Social Outcomes

Although the working assumption of many policymakers has been that homeowning is a good thing for society, the literature on the influence of tenure on social outcomes was sparse until the late 1990s. We now have a better, if still imperfect, handle on how much tenure matters to society. We divide the literature on tenure into four parts: its effect on neighborhood conditions, its effect on civic participation, its effect on children and personal satisfaction, and its effect on labor markets.

The oldest literature involving tenure and outcomes is in the area of home maintenance. In a theoretical paper by Henderson and Ioannides (1983), the authors

develop a model that shows owners are more likely than renters to maintain their houses at an optimal level. Their argument is a principal-agent argument: because owners are both principal (owners of a property) and agent (managers of a property), the incentives of principal and agent are always in alignment. This stands in contrast to rental housing, where the principal and agent are often different people. Indeed, a renter often acts as an agent. The incentives of renters and landlords often are not in alignment, particularly because renters often plan short tenures and landlords plan to hold buildings for long periods. Consequently, it is possible that rental housing units will not be maintained as well as owner-occupied housing units.

This might create an undesirable social outcome, because poorly maintained buildings can produce negative externalities. O'Sullivan (1993) suggests that neighborhoods that physically deteriorate breed crime. Moreover, as buildings lose value, they pay less in local taxes while presumably consuming no less in local government services. At minimum, poorly maintained buildings are esthetically unpleasant.

The empirical literature testing the impact of tenure on maintenance contains at least four papers: Galster (1983); Shilling et al. (1991); Rohe and Stewart (1996); and Gatzlaff et al. (1998). Galster tested the effect of tenure on maintenance effort; using a sample of 559 houses in Wooster, Ohio, he found that owners are 58 to 132 percent more likely to perform maintenance and 84 to 92 percent less likely to have structural problems. Shilling et al. and Gatzlaff et al. tested the effect of tenure on property values. Shilling et al. performed hedonic regressions on a sample of 360 houses in Baton Rouge, Louisiana, and found that after controlling for a variety of physical and neighborhood characteristics, owner-occupied houses depreciated at an annual rate of 0.6 percentage points less than renter-occupied houses. Rohe and Stewart looked at a random sample of census tracts to investigate the effect of the homeownership rate on change in property values between 1980 and 1990. Using two-stage techniques, they found that a 1-percentage-point increase in homeownership produced an $800 increase in value in the average-priced house. Gatzlaff et al. used repeat-sales techniques on 47,329 single-family detached houses followed over 24 years in Pinellas County, Florida. They found that owner-occupied house prices increased by only 0.16 percentage points more per year than rental house prices. Although they found a statistically significant difference in appreciation rates between owner-occupied and rental houses, the significance was in large part a function of sample size: the economic difference between the two tenure types was small. Nevertheless,

the four papers taken together suggest that the Henderson and Ioannides hypothesis could be correct.

Two articles (Rossi and Weber, 1996; DiPaquale and Glaeser, 1999), have appeared in the past 5 years testing the effect of tenure on civic participation. The link between the two seems straightforward. Owners have a financial stake in their communities: when communities are run efficiently and responsively, property values rise. Owners therefore have an incentive to be involved with, or at least monitor, how their communities are run. Rossi and Weber (1996) generated a series of correlations between owning and renting after controlling for socioeconomic and marital status. They found that owners are more likely to be interested in public affairs, read a newspaper, belong to a local improvement group, participate in campaigns, lobby, give money to political candidates, and know the names of their Member of Congress, Governor, and school superintendent. DiPasquale and Glaeser (1999) used a more sophisticated modeling strategy to testmany of the same outcomes. They found that in the United States and Germany, the influence of tenure on civic participation survives a large number of control variables and a selectivity bias correction. Thus, while the literature on tenure and civic participation is short, it has to this point strongly confirmed the view that homeownership produces citizens who are more active in their communities.

Green and White (1997) and Haurin et al. (2000) tested the impact of tenure choice on child outcome. Green and White investigated school outcomes for children of homeowners and renters and found that children of owners are more likely to finish high school than renters, even after controlling for a variety of household and neighborhood characteristics and attempting to correct selectivity bias. Green and White also found that girls under age 18 from homeowning households are less likely to become pregnant than girls from renting households. The Green and White paper features three data sets: the Public Use Micro Sample of the U.S. Census, the High School and Beyond Survey, and the Panel Survey of Income Dynamics.

Haurin et al. used the National Longitudinal Survey of Youth. This article contains an astonishingly long list of control variables, including information on parents' performance on the Armed Services qualifying examination and length of tenure. Once again, the tenure result survives: children of homeowners tend to have better outcomes than children of renters. Specifically, they found that children of homeowners grow up in a higher quality home environment, have higher cognitive

outcomes in math, and are less likely to have behavior problems. This is doubtless the most thorough test so far of the effect of tenure on childhood outcomes, and it continues to confirm that homeownership produces desirable outcomes for children.

Finally, we discuss the one potential dark side of homeownership. Past work suggests that homeowning could produce neighborhood stability and civic involvement. These phenomena could attach households more closely to their communities. Whereas many, particularly those who advocate the creation of "social capital" (Fine, 1999), see such an outcome as an unambiguously good thing, such attachments could also lead to reduced mobility, which in turn could lead to longer unemployment.

Oswald (1997) makes just such an argument. Specifically, he suggests that owners have financial impediments to mobility. Unemployed owners, therefore, have impediments to changing labor markets, which in turn means their search for a new job is constrained. Oswald also argues that homeowners, being civic-minded people, are more likely to regulate development, which impedes economic growth. Thus, he argues, places with high levels of ownership have few new jobs for those who become unemployed.

Oswald backs these assertions with a set of correlations using Organization for Economic Cooperation and Development countries and the United States. After regressing changes in ownership rates on changes in unemployment, he finds that a 10-percentage-point increase in the ownership rate leads to a 2-percentage-point increase in the unemployment rate. In a followup paper, Green and Hendershott (2000) find that the Oswald results do hold up for certain classes of people: older workers (that is, people between ages 35 and 65) and secondary earners.

The problem with the Oswald result (and the Green-Hendershott result, for that matter) is that tenure involves a selection process, one characteristic of which is mobility. Owners reveal themselves to be less mobile than renters (for reasons we discuss below); the Oswald result, therefore, may be getting the source of the constraint on mobility wrong. Green and Hendershott (2001) are engaged in research using microdata to examine whether the owning-unemployment relationship survives a selectivity correction.

In short, we have reasonably strong evidence that homeowning provides a variety of social benefits while potentially creating a social liability. From a policy standpoint, it is important to better understand the relative magnitudes of the costs and benefits and make the correct decisions accordingly.

Why People Become Homeowners

For the remainder of this narrative, we take the view that the social benefits of homeowning described above outweigh the social costs, and, therefore, it is desirable to encourage homeowning. To encourage people to become homeowners, however, we must ask what motivates them to become homeowners. I argue that there are four broad reasons why people become homeowners: they receive secure tenure, they gain management control over their dwellings, market segmentation, and owning is financially attractive.

One of the important reasons people choose to live where they live is to be near their place of work. By purchasing a house, they can essentially hold the cost of their location-transportation decision constant: they know that unless a job change requires that they move, their cost of housing will not increase. Renters are not in such a comfortable position: residential rents generally reset annually, and landlords have the right of eviction at the end of a lease term. This means that renters risk both the price and location of residential space every year; owners do not face such risk. Owners do face asset price risk, but we take up that issue when we look at financial attractiveness.

For renters, the management control question is just as problematic as it is for landlords: the interests of renters and landlords often do not align. For example, a particular renter may find it extremely important to get faulty plumbing fixed immediately; a landlord might not find the problem so urgent. The owner has the option of calling a plumber herself (or going to Home Depot and fixing it herself). Consequently, an owner will always be in a better position to make decisions about how “her house is run” than any landlord will ever be. Moreover, it is difficult to imagine that one could ever draft a contract between landlord and tenant that would anticipate all possible circumstances where the tenant would expect the landlord to take a particular action. Indeed, residential leases tend to be standardized, for the very sensible reason that such standardization leads to lower transaction costs.

There is an obverse of this, of course. For people who do not want the responsibility of maintaining their houses, the fees implicitly charged by landlords to manage property may seem a bargain, and renting might be a more appealing choice on management grounds than owning.

The composite and long-term nature of the commodity of housing means that it is very difficult for landlords to produce housing that matches the exact desires of renters, even for a price. Landlords must expose their units to the market each year, and the depth of such markets for idiosyncratic characteristics could be so shallow that such characteristics could not be justified. However, as Rosen (1974) shows in his classic paper, occupiers of houses have idiosyncratic tastes and are therefore prone to prefer a wider variety of housing than is available in the rental market. When people become owners, they have the ability to live in a dwelling that reflects their tastes and preferences, subject to what they can afford. They can either build a new house to their own design or remodel an existing home that contains desirable features.

The final reason people become homeowners is purely financial: they find owner-occupied housing to be a better deal than rental housing. Models of tenure choice embodying this idea go back many years and include the works of Rosen (1976), Hendershott and Shilling (1982), and many others. The idea is straightforward: If the cost of owning is less than the cost of renting, one becomes an owner. If the opposite is true, one becomes a renter. The determinants of the relative costs include house prices, after-tax interest rates, property taxes, maintenance costs and depreciation, and expected house price appreciation for owners and gross rents for renters. Also important are the transaction costs of owning and renting. When one owns, one must generally pay fees for brokerage, financing, and title searches. When one rents, such costs are generally lower. Given the current structure of U.S. tax policy,[2] it is often more attractive financially to own, unless one expects to move often or one's personal expectations of house price movements are substantially more pessimistic than the market's expectations.

Expected mobility matters because people who move frequently will not be able to amortize the transaction costs involved in owning. Personal expectations about house prices matter because people expecting dramatic falls in house prices (or expecting stagnation in house prices) will not expect the financial return of owning not to be sufficiently high. For instance, in San Jose, the rent-to-price ratio is very low

because owners expect prices to increase. However, if prices remain the same, even the after-tax cost of owning (interest payments, property taxes, etc.) will be greater than the cost of renting.

That said, we do observe substantial numbers of households that are not particularly mobile and yet remain renters. One reason for thisis, of course, that many people want to become owners but cannot because they lack access to capital. This is an issue we must return to when we discuss policy. The other thing we must recognize is that for those at the margin of becoming owners, it is not entirely clear that owning is more financially attractive than renting under the current policy regime. We also return to this subject.

I briefly describe four characteristics that induce people to become owners because, before we discuss policy, we must realize that many people will choose to become owners even without a substantial financial incentive to do so. Thus progressive housing policy that will maximize the amount of homeowning produced per taxpayer dollar should focus on those who either want to become homeowners but cannot or on those who do not have a financial incentive to join the ranks of owners.

Federal Housing Policy and Homeowning

Although there have been a myriad of Federal programs, large and small, to promote homeowning, we focus on four: the Federal Housing Administration (FHA); the government-sponsored enterprise (GSE) status of the secondary mortgage market agencies; the Mortgage Revenue Bond, Mortgage Credit Certificate program; and the interrelationship between Federal tax policy and tenure choice.

FHA, of course, has been a crucial program in helping people overcome capital constraints. It has allowed households with relatively few resources to enter the housing market with low downpayments and partially financed closing costs. As Linneman and Wachter (1989) show, many households who would like to become owners are precluded from doing so because of downpayment standards associated with conventional mortgages. But there may be a spatial problem with FHA. The lowest cost owner-occupied housing is generally in central cities, particularly in the Midwest and Northeast.[3] Because households at the margin of homeowning face payment constraints,[4] they are most likely to look for housing in these central cities. If these households expect that property values in these places will not rise, they may,

entirely for financial reasons, continue to prefer to rent. This issue is particularly pronounced when one considers how leveraged FHA buyers are: any small change in house prices willhave a large impact on the value of owners' equity. All of this is compounded by the fact that central-city markets can be thinly traded markets, meaning that it is not easy to discern price information.[5] Thus, although FHA may enable households who would otherwise not have access to the housing market to have such access, it might also enable households to buy only in places that are perceived as risky and, therefore, not financially desirable. Putting all these things together, it is not difficult to see that, although FHA has some very positive features, it cannot by itself solve the problem of inducing people to become homeowners.

The existence of the secondary market agencies, on the other hand, unambiguously makes it more financially desirable for people to become homeowners. First, the fact that they can borrow money at preferred rates means that conforming mortgage rates are lower than they would be otherwise. Second, because there are limits on the size of Fannie Mae and Freddie Mac mortgages, the benefits of the lower rate are somewhat, if not sharply, targeted to those less likely to find owning financially desirable. The issue with the agencies is not effectiveness but rather economic efficiency.[6] We do not get into the issue of what share of Fannie Mae's / Freddie Mac's preferred borrowing status benefits homebuyers and what share benefits shareholders in those corporations. To the extent that benefits go to buyers, particularly buyers who would not buy otherwise, the economic resources used to create those benefits can be justified.

The Mortgage Revenue Bond program raises many of the same issues as FHA and the special treatment of the GSEs. The program allows States to use tax-exempt bonds to finance mortgages for targeted borrowers and houses. As a result, at least some of the benefits of the program go to the investors in the bonds. At the same time, the program places eligibility limits on house prices and incomes. Although the income limit in many areas commendably targets the benefits of the program toward those on the margin of becoming homeowners, it is difficult to set it properly. In markets where houses are very expensive, the income limit effectively precludes anyone from participating. In less expensive markets, the limit ensures that many who would be owners in the absence of the program take advantage of the program. Although the house price limits undoubtedly help target the program, they once again could push potential buyers toward areas that are not the most financially attractive.

The companion program to the Mortgage Revenue Bond program is the Mortgage Credit Certificate program, which allows borrowers to credit mortgage interest against their Federal income taxes. This program is well designed and targeted and certainly adds to the financial desirability of being a homeowner. The problem is that the Mortgage Credit Certificate is not refundable: Taxpayers for whom the value of the credit is greater than the before-credit tax liability are not allowed to claim the full value of the credit. These, of course, are the households that need the most financial help in becoming homeowners.

We are left with the 800-pound gorilla of U.S. policy toward owner-occupied housing: the interaction of the Federal tax code and owner-occupied housing. This interaction is generally not well understood by the public or policymakers. The fact that mortgage interest is deductible is not in itself specific to owner-occupied housing. Indeed, landlords are allowed to deduct interest against income when determining their tax liability. The preference received by owner-occupied housing is that the income it produces—or the value of the service it produces—goes untaxed. The fact that owned housing produces tax-exempt income makes it stand apart from other assets.

Other countries, such as Italy and Sweden, have attempted to tax imputed rent on owner-occupied housing. According to McDonald (1999), Italy has had a difficult time measuring imputed rent, and Sweden gave up trying in 1991. This, indeed, is the best case for *not* taxing imputed rent—such a tax would be extremely cumbersome to administer. Because imputed rent is so difficult to measure, attempts at taxing it almost surely would produce inequitable outcomes.

Nevertheless, the fact that imputed rent goes untaxed means that the implications for the mortgage interest deduction differ from what many people think. Indeed, households should be indifferent as to whether they finance their houses with debt or equity, because they receive identical tax preferences. The mortgage interest deduction places debt on a level playing field with equity. At first, this suggests that the mortgage interest deduction would help those at the margin of homeowning—young people and lower income people—who do not have easy access to home equity and, therefore, need to get a tax preference on debt to compete in the marketplace with those who get a tax preference with owners' equity. The problem comes from the current shape of the tax code: for many households at the margin of owning, the value of the standard deduction is greater than the value of the interest deduction on a

home they might consider buying.[7] Therefore, lower income and younger borrowers with little equity to put into a house get no benefits from the current tax code.

If we are going to use the tax code to benefit those at the margin of owning, it must contain two features: It must allow households to claim a benefit beyond the standard deduction, and it must be refundable.

Conclusion

There is a growing body of literature on the social implications of homeowning. Generally, the literature shows that homeownership produces desirable social outcomes such as better neighborhoods, more civic participation, and more socially healthy children. The major potential downside of homeowning is that it constrains labor mobility; however, current evidence of the social liability is far less convincing than the evidence of social benefit. Indeed, Haurin et al. (2000) make it difficult to reject the idea that tenure matters to children, as measured by a wide variety of development and behavior variables.

The principal mechanism for making people homeowners is to make ownership financially attractive and help them overcome capital constraints. Current Federal housing policies on tenure tend to do one or the other but rarely both. Much Federal policy regarding homeownership is inframarginal; it helps those who would be homeowners anyway or those who are outside the home-purchasing decision altogether. This situation calls for the development of a program that would make homeowning possible for those who are credit constrained and financially attractive to those who are not A refundable credit would be a good example of such a program.

Endnotes

[1] For a series of quotations, see Green and White (1997).

[2] About which we say more later.

[3] New York, Washington, Boston, and, recently, Chicago are exceptions to this.

[4] Generally, mortgage underwriting guidelines discourage total house payments in excess of 28 percent of gross income.

[5] See Lang and Nakamura (1993) for a discussion of price revelation in thinly traded housing markets.

[6] In contrast to operational efficiency.

[7] This is particularly true for people who live in States without State income taxes. For these people, the threshold level of interest for which the deduction has value is even higher than it is for people who live in States that have income taxes.

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