Risk Reduction Through Home Ownership

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It is often asserted that home ownership provides social benefits. Proponents of owning rather than renting suggest that communities with higher percentages of owner occupied homes have better schools and public services, and that they exhibit the elusive "pride of ownership." But how does ownership affect the individual home owner? An intuitive response is that although ownership provides possible income tax benefits, it exposes the owner to price risk, because the owner is "locked in" to the property. Is this intuitive response correct? Is it unwise for a family to own its dwelling?

Economics is a discipline that provides answers to some questions that cannot be addressed through intuition. Economics therefore is not always a science of common sense; we sometimes must accept the conclusions of economic analysis, even if those conclusions seem peculiar, if we accept the underlying assumptions. The risk reducing aspect of home ownership represents a case in which careful analysis produces counterintuitive conclusions. The correct, although surprising, answer to the above questions is that ownership reduces price risk; an increase or decrease in the price of housing leaves the home owner better off than he or she was before the change. As the paragraphs that follow demonstrate, owning a home is actually good for you.

The Budget Constraint

Each household has unlimited desires for goods and services; who among us does not wish for more of the things that we like to own and consume? This statement does not suggest that people are selfish or irresponsible; one of the "goods" that a family "consumes" might be its support of charities. At the same time, income is limited. A household maximizes its wellbeing (in economics terminology, its "utility") by purchasing the bundle of goods and services that it most prefers from among those mixes of housing and other goods that it can afford to buy with its limited income. (It is possible for us to approach the problem through an analysis in which only one good other than housing is considered; this method permits the two dimensional graphical presentation shown on pages 4 and 5.)

The household's well-being must be maximized subject to a budget constraint: expenses must exactly equal income. The family can spend no more than it earns. Our analysis covers the period of time (perhaps a few months) over which the household plans its major consumption outlays. The period begins immediately after the individual has purchased a house. The entire income earned during the period is assumed to be spent during the period on housing and other goods in the consumption bundle.

Obvious Case: Rising Prices

What if, at the beginning of the period, home prices change? It is intuitively appealing that a home owner is better off if, after the house purchase has been completed, there is a relative increase in home prices. In other words, it may seem obvious that the owner benefits if home prices in the market area rise relative to the average prices of other goods in the bundle consumed by the household.

Yet the reason *why* the owner is better off may not be clear to those who rely on intuition alone. Consider the fact that the owner can sell the house at a profit relative to the purchase price, but that a replacement home within the market area will be accordingly more expensive. A more refined intuitive answer might be that the owner gains because he can sell the house, move to an area where home prices are lower, and buy an essentially identical replacement house for a lower price. But this response is also incorrect; a similar home would sell for a lower price only if the new community offered a less attractive physical environment or a less diversified economic base (see "Housing Affordability: Some Thoughts from a Couple of Skeptics," *ORER Letter,* Spring 1991).

The true reason why an increase in the price of housing leaves the home owner better off is that a new mix of housing and other consumption goods becomes affordable. The owner has the chance to sell the house at the increased market price, buy a reduced quantity of replacement housing, and spend the difference on other goods; an increase in a good's price relative to the prices of other items may cause us to prefer to consume less of the more expensive good and consume more of other goods. (The concept of "more" or "less" housing should not be measured in terms of size alone. In this discussion, and in the graphical analysis that follows, "more" housing should be seen as an increase in housing services: an improvement in size, location, quality, or other features.)

The analysis in the preceding paragraph assumes that transaction costs are low enough not to affect the home owner's decision. What if there is an increase in the price of housing, but transaction costs (brokerage and other costs relating to the transaction itself, rather than to the price of the commodity) are too high to allow the owner to change to a consumption mix that provides greater satisfaction? Then the owner maximizes wellbeing by remaining in his or her present house. In other words, "staying put," and thereby consuming unchanged amounts of housing and other goods, is always one of the consumption choices available to a home owner; an increase in the price of housing cannot move the home owner to a lower level of satisfaction even if transaction costs are high. It should be intuitively clear that a change in relative prices causes a new consumption bundle to become more attractive than the original mix, but that high transaction costs could prevent the more attractive mix from being affordable. The right to "stay put" is a form of *residual;* it accrues to someone with an ownership interest, but not to a renter.

Not-So-Obvious Case: Falling Prices

Perhaps it is not intuitively appealing that an owner becomes better off if the relative price of a home decreases. Yet the owner benefits because, once again, the mix of affordable consumption bundles expands. The owner has the opportunity to sell the house owned at the beginning of the period, replace it with a greater quantity of housing, and spend relatively less on other goods. A reduction in a good's price relative to prices of other goods may cause us to prefer to buy more of the cheaper good and less of other available commodities.

But what if a decline in the price of housing is accompanied by such high transaction costs that the owner cannot justify realigning consumption to include more housing and reduced quantities of other goods? As in the case of a housing price increase, the owner is free to

remain in the current house, and thereby to consume unchanged amounts of housing and other goods.

Conclusions and Caveats

The paragraphs above demonstrate that a price increase or decrease can benefit a home owner; ownership therefore provides protection from price risk. An owner is not necessarily better off than a renter, but rather is better off than he would have been as an owner if prices had not changed. Ownership therefore can be viewed as a form of hedging. Renting, on the other hand, is a form of speculation. A renter benefits only if prices fall and housing becomes less costly; a price increase benefits landlords at tenants' expense.

Of course, an owner would be even better off if he could correctly foresee an impending decline in home prices and could wait to buy until after the price fell. The analysis above also ignores portfolio impacts. A home owner with a business tied to the price of housing (a builder or broker, for example) could suffer such severe income loss from a decline in the local property market that no different consumption bundle could duplicate the prior level of well-being.