



September 6, 2019

Why Subsidize Homeownership? A Review of the Rationales

Homeownership is frequently argued to produce a number of benefits for individuals and society. As a result, subsidies for homeownership—tens of billions of dollars annually—are popular among policymakers and the general public. This In Focus reviews three main rationales for subsidizing homeownership and discusses the difficulties economists have encountered attempting to establish their existence.

Rationale #1: Homeownership and Positive Externalities

Homeownership subsidies are most often rationalized on the basis that homeownership generates positive externalities, also known as spillover benefits. An example of a positive externality is the positive effect homeownership is believed to have on property values. The theory is that a homeowner is more likely than a renter to make investments in their home that, in turn, raise the property values of their neighbors. For example, a homeowner may be more inclined than a renter to paint the exterior of his or her home, fix a hanging gutter, or remove street debris outside his or her house. Although the owner may only be seeking to improve the appearance and resale value of their house, he or she is also positively influencing the values of surrounding properties (the spillover effect).

Proponents of homeownership claim homeownership generates other positive externalities. Homeownership may, for example, create neighborhood stability since owners are more inclined to remain in the community for a longer period of time than renters. Homeowners may also exhibit a greater degree of social and political involvement due to the concern about one's property value. It is suggested that higher rates of homeownership could lead to lower neighborhood crime, foster higher youth academic achievement, and lower teen pregnancy rates. By subsidizing homeownership, the government may be able to align the interests of individuals with the interests of society, which results in a more economically efficient outcome.

Economists examining these suggested effects have been able to establish that a correlation between homeownership and these positive effects exists, but they have also found it difficult to establish causality (i.e., homeownership causes these positive effects). There are a number of reasons for this. First, there may be *observable* differences between owners and renters that are producing these outcomes. Consider the case of youth educational outcomes. Owners and renters typically differ in terms of income and wealth, which are likely to be strongly correlated with homeownership. If a researcher does not account for these financial differences, they may conclude that homeownership is influencing academic achievement when the influence is actually household income and wealth.

Second, there may be *unobservable* differences between homeowners and renters that researchers may not be able to account for, which leads them to infer causality when it is not present. For example, certain traits or attitudes may lead some people to be both homeowners and community activists. Although statistical methods can be employed to overcome the problem of unobservable differences, the methods are reliable only if particular assumptions hold, and whether these assumptions hold is often a point of debate.

A third problem that researchers commonly face in determining causality is the possible existence of an interaction between homeownership and the positive outcome policymakers wish to promote. Take, for example, the claim that increased homeownership rates boost neighborhood property values. Determining causality is difficult because homeowners may prefer to purchase homes in neighborhoods where home values are rising. As with unobservable differences, statistical methods can be used to determine causation when such interdependence exists, but, again, particular assumptions must hold for these methods to produce reliable results.

Because of these difficulties, a definitive answer to whether homeownership produces the purported positive externalities has eluded economists. This limitation, however, does not mean that homeownership does not result in positive externalities that justify housing subsidies. But one could argue that determining cause and effect is essential to proper policy design. And if homeownership does not generate the positive effects some believe it does, then the economic justification for subsidization is diminished.

Often absent from the debate over subsidizing homeownership is the possibility that homeownership results in negative externalities. For example, the same incentive that is believed to lead homeowners to make investments that raise surrounding property values—mainly homeowners' financial stake in their property—may also lead homeowners to push for local initiatives that exclude certain groups of people from their communities. Local zoning restrictions, for example, may be supported by homeowners if restrictions prevent the construction of low-income rental housing that they fear could affect their property values.

If the positive externalities outweigh the negative externalities, economic theory still suggests that subsidizing homeownership to generate socially desirable outcomes may not be the most efficient remedy. If landscaping, painting, and other exterior investments increase surrounding properties' values, it is not clear why

subsidizing homeownership to generate this result is the ideal method. Theories of public finance and externalities suggest that a more efficient policy would be to subsidize the externality-generating activity directly. The government could offer a tax credit, deduction, or voucher for painting or landscaping residential property, for example. Renters and owners alike could then benefit from the incentive while producing the desired result—higher property values from more aesthetically pleasing neighborhoods.

Rationale #2: Financial Benefits of Homeownership

Some contend that homeownership promotes economic equality. Data reveal that homeowners on average earn higher incomes and have higher savings than renters. Homeowners can also use their home's equity to finance discretionary and emergency spending. In addition, homeowners may have greater access to credit to borrow for such things as a child's education, which can increase the child's income, and, in turn, increase his or her ability to become homeowners. Because of these positive correlations, promoting ownership may be a tool that could be used to achieve a more even distribution of income and wealth within and across generations.

Again, economists confront the issue of distinguishing causation from correlation. Does homeownership positively influence one's income and wealth, or is the relationship reversed, and higher income and wealthier households are more inclined to become homeowners? Likewise, there may be some intergenerational wealth transmission mechanism that homeownership helps facilitate, but it could also be that higher-income households are better able to invest in their children. If this is the case, education policies, and not housing policy, may be a more economically efficient way to address income and wealth inequality.

Homeownership is also often viewed as a way to promote the accumulation of an individual nest egg. As long as home prices are stable or increasing, a homeowner, as opposed to a renter, automatically builds his or her net wealth (equity) with each successive mortgage payment. But it is not clear that the financial return to homeownership is as high or as predictable as some believe once depreciation, maintenance, and forgone investment opportunities are accounted for. Instead of purchasing a home, an individual could invest in financial instruments, such as stocks and bonds which are generally viewed as good long-term investments, and which do not require upkeep like a house does.

Policies that promote homeownership may result in households holding relatively undiversified portfolios. To minimize risk, say economists, households should hold a diverse portfolio of assets. Returns should not be too closely related, so as some assets in the portfolio are falling, others are rising. A home, however, is an inherently large and practically indivisible asset. For most homeowners, their house is typically the largest asset in their portfolio. Committing such a large fraction of one's portfolio to a single asset can complicate diversification. Also complicating diversification is the combination of a home

with an individual's other largest asset, his or her human capital, the return to which is labor income.

The Great Recession showed that the return to housing and the labor income of some workers in certain industries or certain age groups may be closely related. Areas with high unemployment also suffered high foreclosure rates, which had a downward reinforcing effect. Thus, from a portfolio perspective, homeownership may not be a financially prudent decision for all Americans.

There is also the concern that unlike most other assets in a typical portfolio, a home purchase is often financed using a substantial amount of debt. This increases the homeowner's exposure to fluctuations in home prices, since mortgage debt amplifies changes in an owner's equity in response to a given price change. If prices fall enough, an individual can end up owing more on the house than it is worth—a scenario referred to as having negative equity, or being “underwater” on the mortgage. Selling a house also requires the owner to incur significant transaction costs, implying that a house is an “illiquid” asset, which further increases risk.

Rationale #3: Psychological and Physical Health Benefits of Homeownership

There is an argument that homeownership bestows certain benefits exclusively to individual homeowners, including improved psychological well-being. The pride associated with owning and maintaining one's home could lead to higher levels of self-esteem and overall life satisfaction. Homeownership could also promote a sense of individual security, stability, and control, leading to less stress than being a renter. As the Great Recession made clear, however, homeownership can also produce the opposite feelings if it becomes a struggle to make mortgage payments or underwater homeowners feel locked-in to their property.

In addition to the psychological benefits, some also point to the possible physical health benefits associated with homeownership. Homeownership may provide higher-quality living conditions that lead owners to be, in general, physically healthier than renters. Homeownership may also allow households to better cope with unforeseen health events by drawing on equity in the home and thus affecting the outcome of certain illnesses.

Researchers studying the psychological and health benefits of homeownership have encountered the same problems as those studying the positive externalities and financial benefits associated with housing—primarily, distinguishing causation from correlation. Some economists have also noted that if these benefits of homeownership accrue to the individual and not to society, then widespread homeownership subsidy programs may be unwarranted. Economic theory generally predicts that when only private benefits exist (i.e., there are no externalities), the market will tend to allocate resources most efficiently. At the same time, one could argue that individual health and well-being are fundamental features of a prosperous society, and if owning a home contributes to one's health, society should subsidize homeownership.

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