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Housing as Asset Based Welfare: A Comment

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Abstract

This paper aims to provide a contribution to the debate about housing as asset based welfare begun in this journal in 2015. It suggests that there are strong reasons associated with life cycle earnings and consumption why owner-occupation can be a desirable option, especially for older households. However owner-occupation can be a high risk option for less well-off households while increasing both inequality across income groups and particularly through its impact on inter-generational income and wealth. Even so, housing inequalities, despite all the market failures associated with its provision and allocation, are more an outcome of broader economic fundamentals. Moreover housing policies can improve the lived experience for many. Policies should aim to provide a tenure neutral-taxation environment but also to reduce credit and other constraints to entering owner-occupation. At the same time there must be support for those with inadequate income to achieve acceptable housing standards.

Key words

Housing and inequality; asset based welfare; life cycle models; housing market risks; intergenerational inequality.

The starting point

The special issue on the role of housing in asset based welfare was extremely interesting, both for the range of issues covered and for the different paradigms discussed. At the end of the introduction the editors asked for the discussion to begin. This note, which provides an input from a more traditional economics perspective, aims to move that discussion forward.

There are at least three main strands of analysis in the special issue: the benefits to the individual household of owner-occupation and the contribution it makes to individual welfare; the role that owner-occupation has played in increasing inequality within each generation and carrying that inequality through to later generations; and the extent to which owner-occupation has increased risks faced by individual households and reduced the potential for risk pooling, in particular through the financialisation of housing (mainly in terms of increased indebtedness). More fundamental issues raised by the papers relate to the underlying distribution of income and wealth, the role and sustainability of more traditional welfare states and the position of housing in the macro economy.

Homeownership and lifetime benefits to individual households

The authors of the introduction start from the traditional argument (which has been well documented using cross European data) that a significant benefit for the individual home owning family lies in the reduction in their housing expenditure when they pay off the mortgage and particularly when they retire and their regular income falls. This is obviously an important benefit to many households but it is also a considerable gain to government because it reduces the welfare safety net that has to be provided to ensure adequate income among the elderly.

This element is however only one part of a more general story of life cycle spending and consumption first put forward by Modigliani and Brumberg (Modigliani and Brumberg, 1954). This suggested that our consumption and savings choices are related to how needs and income are expected to vary over our lifetimes. It is argued in this context that homeownership is a particularly effective way of optimising over the lifespan because, with the help of mortgage finance, consumption of housing and other goods can be stabilised over the lifetime while expenditures can be concentrated in periods when earnings are higher. The asset built up during that period can be run down as other income is reduced by re-mortgaging or transfer into another tenure but also (and apparently without reducing individual utility) by not spending so much on repairs and improvements as we age.

This and similar models were originally developed in an environment of certainty – about incomes, stability of consumption, cost of housing and length of life. Once risks around these variables are introduced the results are not so straightforward but the general principles continue to hold. However it is clear that the benefits are closely related to income and ownership of other assets. The position with respect to income is clear - if income is low or varies such that ownership cannot be maintained there is a risk of homelessness as well as losses associated with forced sales. On the asset front, a richer household with a portfolio of different assets will find it far easier to gain the benefits of choice than those with lower levels of assets. Risk is most heavily concentrated when a household's only significant asset is one particular dwelling which is also their home and there is variability on market values.

In the context of this type of model, it is worth noting that in England and Wales the proportion of homeowners without a mortgage was some 48.5% in the 2011 census and across England exceeded the numbers with mortgage debt by 2014 (DCLG, 2015) – suggesting that the benefits of lower payments in older age dominate financing behaviour. In the USA there is concern that 30% of homeowners aged 70 plus still have debt to pay off (Consumer Financial Protection Bureau, quoted in New York Times, September 2013) as compared to only 8% at the turn of the century (Federal Reserve Survey of Consumer Finances, 2010), again emphasising the benefits of a debt free old age.

In Scandinavia, on the other hand, we see evidence of a more sophisticated approach to debt related at least in part to a more even income distribution and the relative strength of the welfare safety net provided by the state. In Denmark for instance mortgage debt remains high for older owner-occupiers as they re-mortgage in order to spend on other goods and services. Equally in Sweden the vast majority of mortgages are interest-only – so whether households become debt-free as they move towards retirement depends on their wish and capacity to re-mortgage (Lunde and Whitehead, 2016). More generally for those further down the income scale the risks associated with home ownership bear far more heavily. Moreover there are clear issues with respect on the one hand to whether the mortgage market provides the flexibility required and on the other whether indebtedness is a matter of choice rather than necessity.

Homeownership and Inequality

Many of the issues raised above are closely related to income and more general wealth distribution. In this context the main question is whether homeownership reinforces inequality by allowing the accumulation of wealth in ways not available to tenant households (Wilkinson, 1996; Whitehead 1998).

A starting point is that a positive relationship between homeownership and income and wealth inequality is not automatic - as pointed out in the 1980s by Boleat, when he noted that homeownership worldwide was negatively correlated with national incomes (Boleat, 1985). Even in Europe rural housing was historically self-built and therefore owner-occupied, although the extent of security and alienation of rights achieved depended on the land tenure system (and indeed employment conditions) in each jurisdiction. Thus Ireland for instance has had very high owner-occupation rates from the nineteenth century as have many Southern European countries.

Whether homeownership is a major *source* of inequality ultimately comes down to whether access to homeownership and other assets is restricted differentially between groups. Otherwise the *source* of the issue is differential income and wealth more generally with those who are better off able to make a wider range of choices including investing in a housing asset. Homeownership specifically generates inequality in three distinct ways mainly related to the capacity to borrow but also to government taxation policy. First, owner-occupied housing usually generates an asset which can be translated into income and wealth in way that is not available to tenants; second when house prices rise more rapidly than other prices owners (whether owner-occupiers or landlords) make capital gains only available from that asset from which others are excluded; and third tax reliefs and in some cases subsidy favour home ownership through the differential taxation of housing debt, imputed and actual rental income and capital gains.

In addition there are issues around the attributes of owner-occupation in terms of security, choice, the capacity to vary expenditure over the lifetime etc. These may be more available or available more cheaply to home owners than to tenants and can both reduce risks and generate greater control over housing decisions in terms of location, dwelling type and many other variables (Elsinga and Hoekstra, 2005; Whitehead, 1979). It is likely that for owner-occupier households this control is more limited and the relative benefit of owner-occupation may be less both because of more limited choices and because owning may mean they cannot afford to purchase other goods and services that might have higher value. Equally how important these benefits are will depend as much on the nature of the rented stock and the means of accessing that stock - so for instance more vulnerable households may achieve some of these attributes through social renting.

In the context of wealth distribution, perhaps the most basic point to make is that home ownership has in many countries, notably the UK, been the main way in which wealth has become more evenly distributed across income groups. Pension wealth and especially financial wealth are far more heavily concentrated among richer households (Rowlingson and McKay, 2012; Policy Commission on the Distribution of Wealth, 2012). Thus over the years wealth has moved down the income scale as is reflected in the evidence on inheritance which is both more property related and reaches further down the income scale.

What is less clear is whether over the whole population this generates a relatively smooth curve fundamentally related to the distribution of income and wealth or whether there is a sharp divide between owners and tenants. This depend both on the extent of the differentiation and on the extent of exclusion.

Models of intergenerational wealth transfer have become of increasing interest in the theoretical literature (Modigliani, 2008) as they have for policy makers, especially in the housing context (Barrett et al, 2015). The extent of intergenerational inequality arising from home ownership must depend first on the extent of inequality within the older generation. Thereafter the extent to which it is passed on to younger generations depends both on the mechanisms available directly to transfer wealth and income between generations and on the extent to which owner-occupation delivers differential non-financial benefits to children and young people living in owner-occupied housing. With respect to the first the issues are mainly about differential taxation between owner-occupation and those without housing wealth. Any differential impact depends crucially on the specifics of inheritance tax but also on wealth and property taxes more generally as well as on capital gains taxation. Secondly many non-financial benefits are claimed in the literature, notably with respect to security and choice as well as differential access to education and the labour market (Whitehead, 1998, Elsinga and Hoekstra, 2005, Ronald and Elsinga, 2011). Again, though, it is important to disentangle general income and wealth inequality from that relating to the housing asset.

Owner-occupation and risk management

Much of the traditional literature on home ownership assumes that homeownership will be an important source of stability and will therefore reduce individual risk. Yet homeownership carries with it the potential for increasing financial risks which are difficult to mitigate notably because of (i) the specificity of the asset and (ii) the extent of market volatility in house prices - both of which mean there is inherent risk involved in ownership (Whitehead and Yates, 2010). Moreover the leverage involved in using debt finance increases that risk - so for instance if a household has a 90% mortgage and prices fall by 10% they lose 100% of their own equity - but equally if prices rise by 10% they have doubled their equity - which incentivises some groups to take higher risks than they can cope with.

Importantly home ownership is for most households their most important asset which makes it difficult to diversify the household's asset portfolio in line with the extent of their risk aversion. The transactions costs involved in such diversification can also be very high and may make it impossible to achieve a balanced portfolio. Further adjusting housing expenditures to changing circumstances - such as unemployment - can be both very expensive and very slow. All of these factors suggest that a priori that it may be better to transfer risks to a landlord which has a wide portfolio and so can manage risk, both dwelling specific and market, more effectively. What is once again clear is that the extent to which the individual owner can cope with any given level of risk depends heavily on their income and wealth position - a rich individual owning not only a number of homes but also other assets and a range of sources of income has the capacity to manage risk themselves. A household with only one source of income and a single heavily mortgaged property will be facing far more risk and have little or no capacity to transfer or share that risk with others in a better position to manage (Whitehead, 2010; Smith and Searle, 2011).

The State's role in risk sharing and pooling

The question then arises whether the State should take a positive role in ensuring effective risk sharing either within the owner-occupied sector or across tenures. The core issues here in a modern capitalist (or indeed neo-liberal) society are (i) is the government responsible for many of the risks faced by owner-occupiers in which case it can be properly argued that they should have the incentive to mitigate these risks and (ii) given market failures is it the appropriate role of government or to try to reduce these market failures to a point where a reasonably well operating market in risk sharing and insurance can be achieved.

A distinction needs to be made here between risks which can reasonably be insured against - such as fire or at least in principle changes in the value of individual dwellings and those which are systemic. A large number of the more problematic risks relate to macro-economic variables - economic growth, unemployment or inflation, and to variables such as planning policy which are government led. In these contexts it may be appropriate for government to develop their own insurance/guarantee schemes which protect individual decision makers from the impact of change (Miles 2013 and 2015). This is one of the roles of broader welfare benefits such as unemployment pay and indeed of housing allowances which protect individual households from the impact of systemic housing market and debt financing risks.

In relation to market failure there have been many attempts to develop market instruments that can lower risks to the individual household for a premium but most provide very low value for money because of issues around relative information and perverse incentives (Smith et al, 2013;). Equally there have been attempts by governments to encourage market based insurance solutions to protect against mortgage specific risks, including mortgage guarantees and mortgage payment protection models. However these have tended to be ineffective particularly when the housing market suffers a period of major disruption as it did after the global financial crisis.

Many attributes of owner-occupation are exactly those that this group of households might value highly if the system is working well - yet the negative impacts of these risks also falls most heavily on those with limited assets and low incomes. This suggests that there remains a role for the state with respect to risk pooling and sharing - but whether this role should always be housing specific is less clear (Smith and Searle, 2010).

The State's role in ensuring minimum acceptable housing standards

Asset based welfare makes sense in property owning democracies where there are real choices available to all members of that society. Adequate housing is inherently a necessary part of the minimum standards that should be available for all households - although what is meant by adequate housing clearly changes over time, notably as national income rises. In practice therefore the concept is a relative measure in which what is acceptable has moved the minimum physical requirements defined in terms of weather proof shelter, through the provision of housing based services through to neighbourhood and access to local services and employment opportunities.

How these standards are best provided depends on both principle and practicalities. Each dwelling is unique as each household and therefore the value of the dwelling varies across households. This is the core issue for commentators who want to concentrate income related support on households enabling them to choose the dwelling that most closely meets their requirements. Other commentators stress that the market failures discussed above are too great to make it practicable to ensure minimum standards for all through market measures while relying on regulation with respect to both physicality and occupation to meet social objectives.

A much more practical issue is what can actually be delivered. Historically, especially after World War II, the state was often the only actor with the capacity to deliver large scale housing investment. Equally the infrastructure was generally not in place to deliver income related housing support - which is a major reason why housing allowances only became important in Europe and North America in the 1970s. Thus supply side subsidies, including public sector borrowing capacity and public land as well as direct financial payments, went to public and non-profit organisations to provide sub-market rented accommodation.

The position is very different in the twenty first century. In most emerging economies the emphasis is on state supported housing investment together with the development of income related support to lower income households and the development of finance markets to provide owner-occupied housing. Computer and information systems exist to deliver that household based support both to ensure minimum incomes and access to housing. An example of how this is working is Brazil where a 10 million homes programme is being led by the state but the vast majority of that housing will be provided as owner-occupied units with a much smaller role in major urban areas for co-operative housing. No-one suggests that this is a perfect solution - in particular it works far better outside the major cities where there is little incentive for developers to provide (even though they are perhaps the main beneficiaries of the policy. However it is a means of overcoming the lack of either an organisational or a capital base of the sort that supports the provision of social rented housing in much of Western Europe (Garcia Freitas et al, 2015). Many emerging countries across the world, notably in South America and Asia are developing similar owner-occupation based models (Garcia Freitas et al, 2013; Triveno, 2016; Yang and Chen 2014).

Conclusions: housing as asset based welfare

Behind much of the criticism of housing as a part of asset based welfare lie a number of fears (i) that what is implied is less direct support to those who actually cannot afford housing exactly at a time when economic pressures are worsening housing affordability; (ii) that the potential for using housing in this way comes from the financialisation of housing and especially the observed relative increases in house prices which have favoured established home owners at the expense of those unable to enter the sector (iii) that ownership brings with it risks and costs that disproportionately fall on lower income and more vulnerable households to the extent that they are worse off as home owners; (iv) that many of the positive attributes seen as arising from homeownership can be provided as well or better in other sectors; and (v) most importantly, that the emphasis on owner-occupation has significantly worsened income and wealth distribution both within and between generations.

The answer to these criticisms is not necessarily to reject home ownership and in particular the potential security which can go with that ownership. Market based housing and particularly housing finance systems, together with government support through taxation regimes which favour home ownership and wealth more generally have helped to worsen inequality with respect to the bottom end of the scale, especially since the turn of the century. Policies towards both social and private rented housing have often done little to offset these effects. But the way forward is rather to ensure better operating housing systems, which make such benefits more readily available to households across all tenures and to provide direct support for those who cannot afford basic housing standards. A starting point (but one which is politically unpopular in most countries) is to reduce the extent to which owner- occupation is favoured by taxation systems, notably with respect to inheritance and debt, and at the same time to improve access to a wider range of savings/investment products for all households.

Welfare systems do need to change in the face of rising national incomes - but also in the face of worsening distribution of that income. Equally there is nothing inherently wrong in enabling households to have the freedom to choose their pattern of housing expenditure over their lifetime and to support the next generation. But where this has fallen down particularly since the turn of the century is in the massive distortions that have built up in terms of access to these benefits. A significant source of current these problems lies in low - interest rate macro- economic policy which has encouraged real house price increases while tightening access criteria to debt finance since the global financial crisis. Into the longer term the more fundamental issue is market failure in investment markets. Housing is where many of these problems show up most clearly -and impact most strongly on poorer households, but housing is often not the real source of the problem.

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