Crowded House

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The extraordinary growth in the stock market over the past several years has significantly increased in wealth in the U.S. household sector. The Flow of Funds Accounts data indicate that in the second quarter of 1998 corporate equity holdings in the household sector amounted to $9.4 billion dollars or 28 percent of total household assets. This represents an astounding $5.3 billion dollars increase over the past five years. For only the second time since the mid-forties have equity holdings surpassed all other classes of assets in the household sector, although real estate comes a close second at 27 percent.

One might conclude from these aggregate statistics that we are becoming a society of "owners." This is consistent with the rapid spread of indirect stock ownership through retirement plans and mutual funds in the household sector. As Mr. Gates points out, however this view is a mirage. The aggregate data weight each household by its wealth, and therefore the aggregate statistics more closely represent the holdings of the wealthy, rather than the typical household.

In order to examine the asset portfolio of the typical household we need wealth data on individual households. The most reliable source for the U.S. comes from the *Survey of Consumer Finances* (SCF) which is conducted every three years, the most recent being 1995. The SCF data indicate that only 42 percent of U.S. households owned any corporate equity in 1995 through either direct or indirect means, an increase of ten percentage points since 1992. Assuming that equity ownership increased by another ten percentage points between 1995 and 1998 (since market valuation increased by roughly proportional amounts over the two periods), households with corporate ownership now constitute a slim majority.

But even these statistics do not reveal the true extent of the ownership disparity. Figure

the wealth distribution own more equity than real estate. Indeed Mr. Gates is correct in claiming that we are not an “ownership” society when we define ownership to be investment in corporate America.

Why does the typical household invest so little in corporate equity? Financial experts advise individuals to hold balanced portfolios of assets in their retirement accounts, and that exposure to the stock market should increase with investment horizons. Americans may follow this advice when investing pension assets, but they ignore it when investing nonpension assets. Most households in fact hold over two-thirds of their total assets in real estate!

Government policy has been designed to promote home ownership, most notably, subsidies in the form of tax breaks. These policies have been quite successful, with the home ownership rate for the third quarter of 1998 at a new all-time high of 66.8 percent.[2] The subsidies are justified on the grounds that home ownership creates important positive externalities to communities: households that own their home have an equity stake in their community, leading to greater community involvement by the household. The same arguments offered by Mr. Gates for broader stock ownership have been used to justify these and other programs to expand home ownership.

While promoting home ownership is desirable, the current system of housing finance has created a situation where housing “crowds out” other household investment activities. Under the current system, the household must purchase one hundred percent of the house. Partial ownership options are not widely available, which is in sharp contrast to commercial real estate finance where a wide array of debt and equity financing options are available.

Restricting the household to full ownership means that a household must own at least as much housing as it consumes. Consequently, strong tax incentives and consumption motives by households drive them to over-invest in housing (in an optimal portfolio sense). This is not only true for the first house purchase, but also for subsequent trade-up purchases. Figure two presents

article, the concentration of the typical household's assets in real estate increases the portfolio risk. A sharp decline in local housing prices can quickly wipe out the household's housing equity. Compounding this problem is the positive correlation between wage growth in the local labor market and house price appreciation in the local housing market. A collapse in house prices often coincides with increased layoffs and demands for wage concessions by local employers.

The dominance of housing in the asset portfolio also creates problems for retirees. As the household's labor income declines, it needs to use pension and investment income to maintain its level of consumption. However, most older households still have a portfolio that is dominated by an illiquid asset – their house. Although second mortgages, home equity credit lines, and reverse mortgages can all be used to tap into their housing equity converting it into consumption, many older households are reluctant to assume any new debt at this point in their life, and are reluctant to enter into what seems like a complicated financial transaction. Instead they choose to consume close to their income leaving their housing equity untouched.

In addition to promoting home ownership, policies should be devised that facilitate households in achieving a better diversification of their assets. This will only succeed if households can divest a significant portion of their housing assets without giving up their current level of housing consumption. Recently, a new housing finance system called "Housing Partnerships" has been proposed which would allow households to do just that.[3] In a Housing Partnership, a house-buying household (the "managing partner") is matched with outside investors ("limited partners") who supply up front equity toward the purchase of the house. The managing partner assumes all ongoing costs including taxes, insurance, and maintenance, and also retains the right to decide when to sell the house. At the time of sale, any capital gains/losses are divided pro-rata between the managing and limited partners.

Institutional change is difficult in any market, especially one as large and complex as the housing market. For change to occur, there must be a strong underlying incentive at work which

Partnerships. As we have seen, housing crowds out other financial investments by the household, leaving it with a non-diversified portfolio. At the same time, much of the investment risk to housing is neighborhood or community based and can be diversified away by outside investors.

As Mr. Gates points out, current policy is aimed at income-redistribution without trying to connect individuals to income producing assets. Housing Partnerships would facilitate this connection. Only then would the full benefits of an ownership society as envisioned by Mr. Gates come to fruition.

Figure 1: Portion of Households' Assets in Corporate Equities and Real Estate by Wealth Percentile, 1995
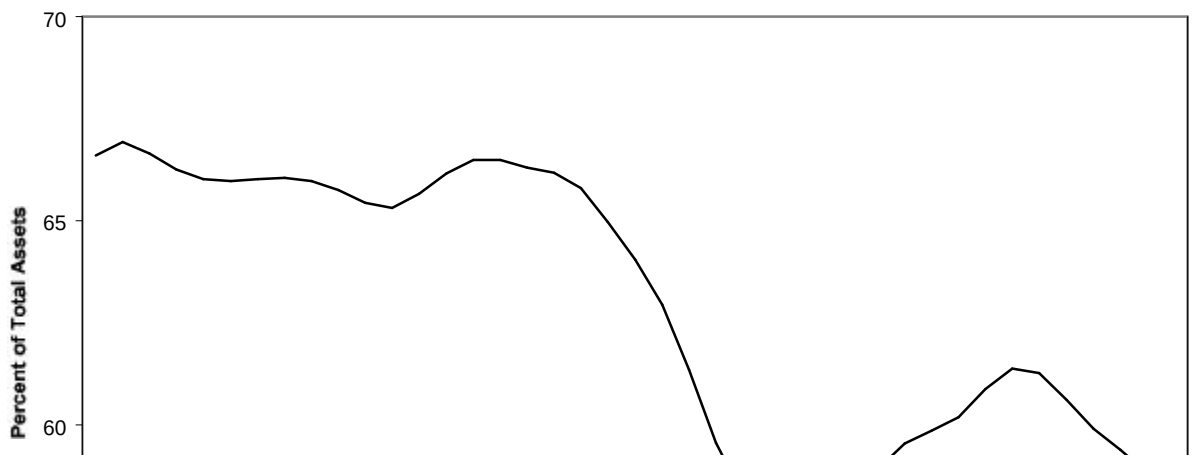
Figure 2: Portion of Home-Owners' Assets in Real Estate Over the Life Cycle, 1995