Is there a really big trade-off? Housing, welfare and pensions reconsidered from a balance sheet perspective

Abstract: A long running debate in the welfare state literature centers on an alleged trade-off between either widespread homeownership and a robust welfare state or widespread homeownership and a robust public pension. Although the literature posits many different mechanisms behind this trade-off, the central assumption in all mechanisms is that homeownership front-loads housing costs and thus creates political sentiment against higher taxes for a larger welfare state. This paper, by contrast, argues two things. First, it questions the central assumption that buying is inherently more costly in the present than renting. Instead, it suggests that the need to reduce financial risks from mismatched maturities on balance sheets is what drives any observable trade-off. Thus, second, to the extent that we observe a housing vs. pensions trade-off, the trade-off is not between homeownership and welfare (or pensions) per se, but rather a trade-off between debt-financed homeownership (but not homeownership per se) and pay as you go pensions. The need to reduce maturity mismatch on balance sheets creates a continuum from societies with high levels of mortgage debt and funded pensions (whether public or private) and societies with debt free free ownership and essentially pay as you go (PAYGo) pensions.

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Is there a really big trade-off between owner occupied housing and either a robust welfare state or a robust public pension system? This is the subject of a long running debate in the welfare state literature between Jim Kemeny (1980, 2005), who argues for the broad trade-off against a robust welfare state, and Francis Castles (1998; Castles and Ferrera 1996), who argues for a narrower trade-off against a robust public pension. Although the subsequent literature posits many different mechanisms behind this trade-off, the central assumption in all mechanisms is that homeownership front-loads housing costs and thus creates political sentiment against higher taxes for a larger welfare state. This paper, by contrast, argues two things. First, it questions the central assumption that buying is inherently more costly in the present than renting. Instead, it suggests that need to reduce financial risks from mismatched maturities on balance sheets is what drives any observable trade-off. Thus, second, to the extent that we observe a housing vs. pensions trade-off, the trade-off is not between homeownership and welfare (or pensions) per se, but rather a trade-off between debt-financed homeownership (but not homeownership per se) and pay as you go pensions. The need to reduce maturity mismatch on balance sheets creates a continuum from societies with high levels of mortgage debt and funded pensions (whether public or private) to societies with debt free ownership and pay as you go (PAYGo) pensions.

This paper has four parts. First it surveys the existing trade-off literature to show that most posited mechanisms linking owner occupation to diminished welfare state provision rest on a central assumption, namely that buying owner occupied housing puts more financial stress on young households than does renting. The second section contests this assumption, showing that this can only
be true to the extent that state policy favors renting over buying. In other words, a society of renters is no more natural than a society of owners. Both are creatures of state policy. The third section, however, posits a different mechanism that can produce what looks like an apparent owner occupation versus welfare trade-off. It demonstrates that successful state efforts to reduce maturity mismatch risk on banks’ balance sheets create a link between indebted ownership and funded pension plans, rather than a link between ownership and smaller public pensions per se. The fourth section considers the policy implications of this revised understanding of the trade-off for recent state efforts to promote (and academic debates about the promotion of) asset-based welfare, while also trying to bring some closure to the debate about the owner occupation versus welfare debate. This debate matters because housing is typically most households’ single biggest expense, pensions are most states’ single biggest budget item, and mortgages often the largest private debt instrument in most financial markets.

*The really big trade-off debate: owner occupation versus welfare?*

The alleged higher cost of purchasing housing as opposed to renting lies at the heart of the trade-off literature. This distinction drives the classic arguments about the inverse relationship between owner-occupied housing and the development of the welfare state generated by Jim Kemeny (1980, 2005) and Frank Castles (1998). These arguments were genetic, focusing on how home-ownership affected the development of welfare state provision. Kemeny argued that the greater the degree of private ownership, the weaker and smaller the entire welfare state would be. Castles made a narrower and more precise claim that higher levels of private homeownership produced weaker and smaller public pensions, particularly second tier pensions. Later arguments, like Ansell (2014), refined both positions by offering supply and demand side political arguments focusing on welfare state retrenchment and efforts to develop an asset-based welfare state (see Stamsø [2010] for a survey). Finally a recent effort by Delfani, DeDeken, and Dewilde (2014; 3D hereafter) presents a thorough critique of the debate, and, following Esping-Andersen (1990), attempts to ground a new typology in the degree to which housing and pension provision are each decommodified. 3D correctly argue that the housing versus welfare trade-off is not straightforward, and even more so that arguments favoring asset-based welfare badly misconstrue the utility of owner-occupied housing as an asset. But in generating their typology they also lack a mechanism beyond the alleged higher cost of buying as compared to renting. [Neda, please correct me if I am wrong about this] This section transits the trade-off literature to arrive at section two, which shows that buying is not inherently costlier than renting and thus that the essential difference is liquid versus illiquid housing finance markets and not renting versus ownership.

We can divide the trade-off literature on the basis of whether the argument is genetic or transformative, that is, about the build out of the welfare state or efforts to transform it in ways that de-socialize risk. Most of this literature implicitly or explicitly starts from voter preferences. Genetic arguments ask whether and how voters choose between having houses or having (more) welfare. Transformative arguments ask how incumbent homeowners react to changing asset values as they weigh the risks of self- versus social- insurance.

The original Kemeny versus Castles debate was genetic – the level of homeownership determined how big a welfare state could be constructed, as voters confronting cash constraints opted either for ownership or welfare, but not both. Kemeny posited a trade-off between owner-occupied residential property and the quantity and quality of welfare state benefits. Although the total life-cycle cost of

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1 First tier, or basic pensions are typically relatively flat, tax financed, pay as you go pensions designed as insurance against poverty in old age. Second tier, or wage related pensions can be organized on a defined benefit or defined contribution basis, and provided a payout linked to one’s earning power over one’s lifetime, thus providing something close to the recipient’s pre-retirement standard of living.
owner-occupied or rented housing was the same at any given level of income, the temporal distribution of those costs varied. Kemeny argued that would-be owners had to save for a down payment varying from 10 to 50 percent of the purchase price and then faced a front-loaded schedule of payments as they amortized a mortgage over the next 15 to 30 years. Buying a house thus seemed to compress the bulk of the life-cycle cost of housing into a household’s early years. Kemeny argued that renting, by contrast, involved more level payments across the entire life cycle. The frontloading of housing costs for owner-occupiers inclined them against higher taxes for social services and transfers, as these taxes competed in the household budget with saving for and then amortizing a mortgage. Kemeny is thus an argument about voter resistance to state revenue raising, about tax politics.

Although Kemeny (2005) softened the causal claims made in Kemeny (1980), he did not retreat from his underlying assumption that the frontloading of housing costs was the critical causal factor explaining the relationship between high homeownership and low social spending. Kemeny thus argued that the level of home ownership was not a natural outcome of rising or high per capita income levels, but instead reflected political choices by voters and parties. Prescriptively, Kemeny thus argued for state policy that avoided promoting homeownership, and instead made renting as attractive as owning. This would generate what Kemeny called integrated housing systems, rather than dualist ones. In dualist systems, renting was a lower quality option with public rental housing a command and control system for the poor. Meanwhile private market-based rentals and subsidized home ownership stood apart from that public housing. In integrated systems, systematic subsidies to renting made renting an attractive option for all social classes.

Frank Castles (1998) narrowed Kemeny’s claim, arguing for a specific and functional trade-off between individual homeownership and robust public pension spending. Housing potentially constitutes not only the single largest item in most retirees’ budgets, but also, with food, one of the least substitutable or dispensable. For Castles, the imputed income from freehold homeownership was a functional substitute for public pension income. Castles made a genetic argument that settler societies with high levels of homeownership prior to the emergence of public pension systems were least likely to develop robust public pensions, because freehold ownership of housing substantially reduced the income requirements of the home-owning elderly. Echoing Kemeny, Castles also noted that better off parts of the elderly population were more likely to own houses and thus were less favorably disposed towards higher taxes to provide cash income to elderly renters. In addition, while both renters and owners bear the cost of any property taxes, these taxes are most visible to owners, and thus draw the most resistance (Martin 2008). Private, debt-financed homeownership split the natural elderly constituency for expanded social spending along tenure lines. Castles and Ferrera (1996) made a similar argument about southern Europe, arguing for a distinctive combination of private but debt free homeownership and weak state taxation capacity. Debt free ownership emerged from the combination of a large rural population and considerable tax evasion through the cash purchase of property. In turn, weak taxation capacity limited the universality of public pensions. Where Kemeny focused on the revenue side of the welfare state, Castles focused on the expenditure side, and, in the article with Ferrera (1996), on a state rather than social basis for the trade-off. But like Kemeny, Castles (1998:17) was cautious about the direction of causality between home-ownership levels and spending levels, and also largely saw spending as an outcome driven by voter preferences.

Gösta Esping-Andersen (1985) anticipated part of this debate about genetics, but with a psychological rather than financial mechanism. Esping-Andersen looked at how individual homeownership demobilized the working class by pitting owners against renters and creating a psychology of personal gain. Like Kemeny, he focused on the revenue side of welfare state expansion, but with a different psychological animus against increased taxation.
Finally, Dalton Conley and Brian Gifford (2006) analysed and reversed some of the Kemeny and Castles findings (Fahey and Norris [2003] make a similar qualitative argument). Like Kemeny and Castles, Conley and Gifford argue that the critical political impediment to higher social spending was the frontloading of housing costs on lower income home purchasers. Despite this point of agreement, Conley and Gifford argued that homeownership represented a self-insurance response to low levels of social insurance. This genetic argument reverses the causality in Kemeny, though Conley and Gifford were cautious about placing too much weight on this specific finding. Conley and Gifford note that widespread homeownership appears to blunt wealth and consumption inequality even if it does nothing to ameliorate income inequality. Conley and Gifford, however, provide a bridge to non-genetic arguments looking at welfare state retrenchment rather than build-out.

Those non-genetic or transformative arguments rest on the partisan use of housing policy to affect individual preferences, and the partisan consequences of the asset accumulation afforded by private home-ownership. Where Kemeny and Castles made unmediated leaps from homeownership to voting preferences around welfare state development, David Malpass (2008) and Ben Ansell (2013) separately look at how homeownership affected the politics of cutbacks in mature welfare states, rather than its build-out. They both argue, albeit in different ways, that voting preferences are sensitive to households’ asset holdings. In the same spirit as the original arguments, they argue that rising asset values enable a belief in self-insurance. This diminishes voter preferences for a broader welfare state, instead motivating either a preference or tolerance for cuts. Malpass (2008) notes that once we move out of the rarified atmosphere of the top 10 percent, most household wealth takes the form of non-financial assets and that housing is by far the pre-dominant form that those assets take. Ansell’s argument is similarly motivated by changes in asset (i.e. housing) prices. He finds that rising house prices in the United States, Britain and Germany motivate a preference for self-insurance over social insurance. Though this belief may be flawed – housing prices in the United States historically do not rise much above inflation, and the size of housing and financial assets covaries for most people while varying inversely with their risk of unemployment – it may well be a social fact motivating preferences for greater or lesser social spending (see Langley 2008). Ansell also demonstrates, however, that falling asset values – falling housing prices – can motivate a preference for expanded social welfare, suggesting that voters accurately assess their relative exposure to risk at any given point in time, even if they do not make an accurate lifetime assessment of risk. Doling and Horsewood (2011) similarly argue that it is the expectation of capital gains that drives a preference for owner-occupation. And more finely grained national studies, like Tranøy (2009) on Norway, attribute political pressure to commodify social or cooperative housing to capital gains hunger by incumbent renters. Malpass and Ansell supply the partisan basis for the shift of the housing versus welfare debate into a housing as welfare debate, in which housing is the largest component of the asset-based, self-help, self-insurance welfare system preferred by the OECD and governments looking for ways to cut spending.

Finally, Delfani, DeDeken and Dewilde (2014; ‘3D’) provide the most cogent assessment of the nature of the housing-welfare trade-off, including its expansion into asset-based welfare arguments, by building on the decommodification framework in Esping-Andersen (1990). 3D argue that the trade-off is mostly a spurious correlation, and thus that asset based welfare will not work in all societies characterized by high home-ownership. For them the critical issue is the institutional structure of the housing and pension markets. They focus on the degree to which housing and pensions are commodified. If housing is not commodified – a situation they identify with Southern Europe – then it cannot serve as a substitute for a pension or broader social insurance because the ‘value’ inherent in the dwelling is not liquid. Housing can only provide consumption services. By contrast, in commodified housing markets, like those in the Anglo-economies, houses can serve as pension and welfare substitutes because the cash locked up in the dwelling is accessible through home equity loans and reverse mortgages. In
between, partially commodified housing markets and pensions systems, like those of northern Europe, have housing systems in which the consumption function of the house predominates over its asset function. Consequently, partially decommodified public pensions also predominate. 3D thus replicate and expand Esping-Anderson’s (1990) three worlds of welfare capitalism into five types combining differing degrees of housing and pension decommodification.

3D are on the right track in looking at the institutional structure of housing and pension markets, and their analysis is a strong improvement on the preceding literature. But their allegiance to Esping-Anderson’s theoretical framework and the orientation to the asset-based welfare policy debate leads them to misread the nature of the trade-off. And they lack a mechanism, instead proffering a typology in order to dismiss earlier claims about a trade-off. They take an important first step towards understanding a potential mechanism creating a trade-off by pointing to the lack of a liquid housing market in the Southern European countries, and only partially liquid markets in northern Europe. But they do not take the necessary second step to ask why that market is illiquid and what that implies for the pension system (and the opposite).

To fully understand how housing and welfare systems interact, and the nature of any trade-offs, we need to correct some of the initial assumptions of the debate and move past the policy debate about asset-based welfare. First, it is not at all obvious that buying a house automatically front-loads costs relative to renting. Rather, the relative merits are highly sensitive to the legal structure around mortgages, and the broad range of state subsidies brought to bear on all forms of housing. These can make ownership or renting more attractive, depending on the direction of state policy. Second, the critical distinction is not between the level of home-ownership per se and the level of either welfare or pension spending per se. Rather, the critical issue is how home-ownership is accessed, which is to say, the nature of the mortgage market. Approached this way, the trade-off becomes one between liquid mortgage markets and funded pensions on the one hand, and illiquid mortgage markets and PAYGo pensions on the other. The next two sections make these points in more detail.

Is buying really more costly up-front than renting?

The core assumption in the owner-occupation versus welfare/pension trade-off is that buying housing is more costly in the short and medium term than renting, and that buying frontloads costs. Renting smoothes housing expenses over the life cycle in the original trade-off model. But it is not at all obvious that buying is more expensive than renting. Put aside any aesthetic or psychological benefits from owning rather than renting; these are hard to assess and monetize even though they are real considerations and possibly explain much of the secular growth of home-ownership in the OECD.

Instead, the frontloading of costs in home buying central to the arguments above resolves into the single factor of the down payment, which is a cost that is subject to considerable policy intervention. The only way renting can be systematically cheaper than buying over, say, a ten year time horizon is if renting is subsidized or if the transaction costs involved in buying housing are substantially larger than those involved in renting. Conversely, the only way home buying can systematically be cheaper than renting is if home-ownership is highly subsidized by the state. Why?

The assumption that buying frontloads while renting smoothes rests on an incorrect understanding of how to handle housing costs for owners in the post-mortgage period, and conversely of how depreciation of rented property is handled. Imagine two identical housing units, one of which is occupied by an ‘owner,’ i.e. someone with a mortgage debt contract to the financial markets, and one of which is occupied by a renter. Their running costs are identical, because behind the renter is a landlord who is functionally no different from the home-buyer with respect to the connection to financial markets, and who has to pass along all costs to the renter.
What are our buyer’s costs? Our buyer obviously pays interest on her mortgage loan, and probably some part of the principal to amortize the loan. She also pays property taxes and must pay for any repairs (or do them herself). If our owner were able to secure, say, a 40 year interest-only loan, and made no principal payments, she would face continued interest costs over her entire lifetime. In effect her situation would be like a rental with aesthetic control (and perhaps with control over costs, if the interest rate were fixed). Indeed, in the United States it is common to speak of ‘renting from the bank’ with respect to having a mortgage. Principal pay-down is thus what allows the owner to live ‘rent-free’ during retirement (or the post-mortgage period).

What about a renter? She makes a single payment to the landlord... so the real issue is the cost to the landlord of supplying rental housing to the market. What are those costs? Our landlord faces exactly the same situation as our hypothetical buyer. The landlord must obtain a mortgage to finance purchase of the rental property. In theory, that mortgage will be amortized on terms that are similar to those the would-be owner-occupier faces. In practice they are often worse. In the United States mortgages for rental properties with more than four units substantially shorter amortizations and higher interest rates. The typical home-purchase mortgage amortizes over 30 years, while the typical commercial mortgage amortizes over a five to 10 year period. This raises the front-end cost of providing rental housing, but for the purposes of the argument, make the conservative assumption that landlords borrow on the same terms as homeowners. The landlord, like the buyer, will face costs of purchase that include both interest and principal pay-down, as well as any property taxes and repairs (although large landlords can gain some economies of scale in maintenance and in the incidence of repairs). A rational landlord will pass along all of these costs to the renter – that is, renters are paying for principal and repair costs just as much as would-be home-owners.

A landlord who did not pass along any of these costs, including principal, would soon be bankrupt in the absence of any offsetting incentive to keep rents below market levels. These incentives do exist, do matter in the supply of rental housing, and are often administered through the tax code. Thus in Australia, the entire ‘buy-to-let’ phenomenon (i.e. buying a dwelling and renting it out) rests on the fact that the tax system allows landlords to deduct losses on rental income from their main wage income (‘negative gearing’). With a marginal income tax rate of 47 percent, and a belief in fairly brisk real rates of price appreciation, buying a dwelling and enduring a running loss in the hopes of reaping a capital gain becomes (somewhat) rational. Similarly, Germany’s tax code waives capital gains taxes on the sale of rental property. This encourages private landlords to enter the market even though rent controls hold rents somewhat below the true economic cost of acquiring the property.

Now it is possible that a landlord who inherits property might charge only variable costs rather than the full principal and interest cost that a landlord who is not as lucky has to charge. But in that case the landlord has voluntarily offered a subsidy to the tenants – there is nothing automatic here that makes renting cheaper in the short or medium term. Indeed, most people would regard this landlord as being unduly charitable, unless the intent of the below market rent was to allow her to fully screen the renter pool for the best possible tenants. In this case the slightly below market rent is offset by the better characteristics of the renter – fewer repairs, no missed payments, etc. – which presumably have some monetary value. The lower rent here is in this sense just like ‘efficiency wages.’ Alternately a public authority or cooperative might offer rents below their cost of acquiring or constructing dwellings – but then someone has to provide a subsidy.

Quite aside from the fact that renters pay the full cost of buying the property on behalf of the landlord, we might imagine that renting property involves costs above and beyond those faced by an owner, and which a rational landlord will pass on to the renter. As XXXX (XXXX) points out, owners have an incentive to exercise more diligence in maintaining the property and preventing excess depreciation than do
renters (unless those renters have some expectation of a long, secure tenure). Landlords also cannot be certain of full occupancy and thus continuous cash flow. For these reasons they might price rentals a bit above the actual monthly costs of their mortgage, property taxes and insurance. Finally, landlords face opportunity costs: they need to obtain a rate of return commensurate with that in other financial markets, including, importantly, on their own investment of a down payment or purchase money. Otherwise why buy property, when equities might give better returns with fewer day-to-day headaches?

The idea that renters and buyers face identical costs runs against our common sense. But our common sense is influenced by an apples to orange comparison. We typically associate owner-occupation with single-family homes and renting with multi-family buildings. Single family homes do cost more than multi-family units on a per square foot/meter basis, because they have significantly lower economies of scale with respect to construction and infrastructure. Single-family homes house fewer people per unit of land (which is why homes tendentially grow bigger each year, as builders try to maximize revenue per unit of land). Single-family homes, all other things being equal, are less amenable to mass-production construction techniques that might reduce the building cost per square foot/meter. But the relevant comparison here is not single-family versus multi-family dwellings. Young households entering the housing market are not buying McMansions in tony neighborhoods. They are buying condominiums, small starter homes, or units in apartment buildings. On a like versus like comparison, these should cost about the same as renting, with the salient exception of the need to accumulate a down payment. But politically, our young household is renting at the time of the decision to buy – so if they find taxes get in the way of accumulating a down payment, why not just continue to rent and meanwhile agitate for better social programs?

Renters and owners thus face identical running costs. The frontloading of housing costs thus resolves into the matter of down payment or purchase money, although even there renters in private markets often must deposit as much as two or three months rent to gain access to the unit. Equally so, landlords’ desires for a return on investment imply that they will also try to recoup their own down payment, so that rents may also include a component for this amount. While both the landlord and owner must make a down payment, the landlord presumably has sufficient initial capital or income to be indifferent to the effects of a smaller welfare state, while our buyer faces a trade-off between purchase money and taxes. Here is one point where state policy clearly matters in leveling the playing field between renting and buying. Many states had or have programs that allow first time homebuyers to save down payment money tax free, generally by depositing this money into specialized banks providing mortgage loans. Thus, for example, in pre-1980s France and Germany savers could put money into special contract accounts that gave them access to below market interest rate mortgages and also sometimes qualified them for government bonuses, Australia supplied grants to first time buyers based on their level of saving, and Spain administered a failed contract savings program. And in Sweden, the ideal case of a Kemeny-type integrated rental market, down payments of 1 to 5 percent were deemed acceptable (Boleet 1985). This might seem to validate Kemeny’s point that homeownership is politically constructed. But it is equally true that mass rentals are politically constructed. We return to this point after a brief consideration of Castles’ argument that homeownership is a functional substitute for a pension, because this also seems to imply frontloading of costs.

At any given point in time renters and buyers in a neutral housing market face essentially the same costs. What then of Castles’ argument that owning is a functional substitute for a pension? If buyers and renters face identical short run costs, why then can owners live ‘rent free’ once the mortgage is paid off? What value are they consuming? The answer is that they live rent-free only if they are depreciating the property. (And systematic visits to houses whose owners have vacated on account of death after a long life quickly reveal the degree of depreciation, non-upkeep, and non-updating during retirement.)
Eighty year old pensioners do not typically replace their furnaces with the most efficient and durable appliance, or put a 50 year roof on the house.) A second thought experiment shows why. Imagine that our renter and our buyer again each obtain access to identical dwellings, and that the interiors of these dwellings fully depreciate after 30 years. Both our buyer and our landlord would have to replace appliances, wallboard, paint, flooring, etc. at that time. Each could spread out the cost of this by sequencing repairs, or do everything at once by taking out a new loan and then amortizing costs over the term of the loan. Doing so creates a new stream of payments from our notional owner to financial markets. These payments would be in addition to taxes, insurance, etc. So our owner hardly lives rent-free. Our owner could choose to defer maintenance and live with depreciated surroundings. But what they are doing is consuming the asset. Eventually someone will have to carry the cost of this deferred maintenance – typically the heirs who will sell the unit at some substantial discount to a fully maintained property. Similarly our landlord could choose to defer maintenance, but this comes at the cost of a lower rental price point unless there are shortages of housing or discriminatory housing markets that permit slum-lording. Most landlords will try to build the cost of renovation into the rent level. If they cannot do this because of rent regulation, that does not indicate any intrinsically cheaper nature of renting as compared to owning. ‘Rent-free’ living for home-owners is asset-burning living, not the consumption of prior frontloaded costs.

Our mortgage-free owner certainly has lower demand on her cash flow than our renter, much as Castles points out. But this does not establish that the owner has had prior higher cash outgoes than the renter during the period of time during which the house was being purchased, which is the core mechanism in the trade-off arguments. In any market free of subsidies, the cost of buying and renting an equivalent unit should equilibrate.

However there are no markets unmarked by subsidies to one side or the other of the rent or buy equation. Rental societies have heavy subsidies to renting. Home-owner societies have heavy explicit or implicit subsidies to owner-occupation. The United States, which has a relatively high rate of owner-occupation, also has multiple subsidy vehicles for home-ownership. The single largest is tax deductibility for mortgage interest. In recent years, this amounted to about $70 billion in 2013, or 0.4 percent of GDP (CBO 2013). Property taxes and state and local taxes are also deductible under certain circumstances and roughly equal the mortgage interest deduction in scale. These deductions subsidize both suburbanization and owner-occupation and at one percent of GDP are non-trivial. The implicit federal government guarantee of the credit-worthiness of American mortgage giants Fannie Mae and Freddie Mac, which became explicit with the nationalization in 2008, appears to have lowered mortgage interest rates over the long term by roughly 25 basis points (0.25%), which is also non-trivial. The Federal Housing Administration (and some similar, but more narrowly targeted agencies) insures the mortgages of low-income borrowers, enabling them to purchase housing with minimal down payments, often as low as 5 percent. This removes one of the largest potential sources of frontloading for the weakest buyers. By contrast, the total budget for the federal Housing and Urban Development Department, only part of which is used for rental subsidies, amounted to roughly $50 billion in recent years. And US housing market intervention is trifling compared to the implicit subsidies provided by the Dutch government, whose mortgage interest tax subsidies alone amount to 2 percent of GDP (Vandevyvere and Zenthöfer 2012: 3). In Denmark, state policy gave mortgage bonds a monopoly in the long maturity private bond market. Finally, the weak tax collection systems prevalent in southern Europe can also be understood as a subsidy to the self-provisioning of home-ownership. As Allen et al. (2004) note, extended families in southern Europe buffer themselves from life and economic risks by pooling resources to build or acquire housing, and providing housing to each other as needed.
Equally so, large subsidies also mark societies with higher levels of social and market based rental housing. Virtually all social housing in western Europe was funded with subsidized loans or privileged access to the central government fisc. Mortgage bonds from Danish cooperatives share the monopoly of issue with private home-owners. The Swedish state used funds from the new (in the 1960s) wage related pension scheme, the ATP, to fund the million house project of the same decade. Norway’s Housing Bank had access to the state for loanable funds. France mandated that firms spend 1 percent of their wage bill building housing or supplying funds to build apartments. The Netherlands state provided mortgage subsidies to social housing organizations equal to 0.8 percent of GDP annually by 1994 before buying off all future obligations at a cost of 5.5 percent of GDP in 1995 (Vandevyvere and Zenthöfer 2012: 7). After that, the Netherlands state was content simply to guarantee mortgage for social housing corporations, much as the US state subsidized owner-occupation via Fannie Mae and the FHA. Dutch social housing organizations also have access to subsidized loans from the Bank of Dutch Municipalities (Bank Nederlandse Gemeenten). All this helped push the share of social housing in the Netherlands to the highest levels in western Europe, at roughly one third of all dwellings, even as private homeownership rates also rivaled those of the Anglo-economies. The critical thing to note is that in all these systems the state deducts tax resources or tax expenditures to lower the relative cost of renting. Subsidies for rentals are no more ‘free’ than those for housing, even when those subsidies simply take the form of loan guarantees and so appear to be costless. As nationalization of Fannie Mae and Freddie Mac in 2008 shows, those obligations do sometimes come due. So it cannot be the case that renting confronts young households with lower housing payments at the cost of higher taxes. Renters’ higher taxes are subsidizing their rents. There is a trade-off between renting and owning, but it is a politically constructed trade-off in which tax expenditures fund private ownership and tax-based subsidies fund cheap rentals.

The only clear upfront cost borne by homebuyers is the down payment, and that cost is determined by political decisions about financial regulation. It is not intrinsically higher relative to renting. If the cost of buying and renting is essentially the same, what then drives the apparent trade-off between homeownership and a large welfare state? In the next section I offer a state side rather than society/voting based mechanism rooted in instabilities that arise on bank balance sheets from mortgage finance and state desires to stabilize the financial system in the face of those risks.

*Maturity mismatch and the trade-off between funded and PAYGo pensions*

Linked political and financial mechanisms are the cause of the apparent trade-off between homeownership and a smaller welfare state. The political mechanism is the state’s desire to and ability to intervene in financial markets to prevent financial crises. The financial mechanism is banks’ desire to avoid the risks of carrying maturity and, to a lesser extent, interest rate mismatches on their balance sheets. The trade-off is not between ownership as such and welfare or pensions as such, but rather between indebted home purchase and pay as you go pensions. Because PAYGo pensions are virtually always organized by the state, high levels of homeownership appear to inhibit state spending. But high levels of indebted homeownership are necessarily connected to *funded* pension plans, which are almost always private. The increased size of funded plans – the substitution of private pensions for public pensions – is what makes the state share of welfare spending seem smaller. Where homeownership is organized without much debt, PAYGo plans prevail, because the balance sheet mechanism linking indebted homeownership to funded plans is not present. Re-conceptualizing the ownership-pension trade-off as a trade-off between ownership and PAYGo plans helps make sense of the otherwise anomalous southern European economies characterized by high levels of homeownership and largely *public* PAYGo pensions, and the otherwise anomalous Danish pension system, which is characterized by a large, funded and *private* second tier pension.
Balance sheets link indebted homeownership (or its absence) to the structure of pensions. Put simply, all financial assets on a balance sheet must have a corresponding liability on someone else’s balance sheet. What are commonly called ‘assets’ in everyday language are not the same things as financial assets. A financial asset is a tradable claim on an income stream. Assets in common parlance can exist without liabilities. But a claim on a stream of income implies that someone else must supply that income and thus carries a liability. So all financial assets have a matching financial liability. This simple relationship has three major implications. First, in any housing market based on debt financed individual home-ownership, some financial actor must be willing to carry the asset mirroring that homeowner’s liability on its books. In turn, that financial entity must finance its purchase of assets by accepting some liability (-ies) to other actors. Second, housing is an illiquid and costly physical asset, and thus most often requires long-term financing. But this requirement does not guarantee that long-term financing will be available. If mortgages are financed through normal bank deposits, this inevitably creates a maturity mismatch in the financial system, with the resulting risk borne either by households or by financial institutions. Third, in the absence of a system for mitigating maturity risks both for households and for financial institutions, private, debt-financed homeownership will be difficult. Either households will not be able to generate the funds needed to purchase a dwelling on an accelerated basis, or banks will not be willing to offer long-term finance. This correspondingly implies that either housing will be in shorter supply or that the state will have to step in and directly provide housing, or, as in southern Europe, that households will produce housing on their own, often in informal ways. The critical force here is the risk that flows from maturity mismatches.

Maturity refers to length of time before a given debt must be repaid. A loan or bond with a one-year maturity must be repaid in one year; a ten-year loan or bond after ten years. Maturity mismatches occur when an organization borrows in credit markets on a short-term basis and then reinvests the proceeds into less liquid, longer duration assets. Banks, for example, borrow short-term from depositors and lend long – sometimes – to homeowners and industrial firms. Mismatched maturities are dangerous. If the short-term lender calls in her loan (e.g. a deposit) from the actor (e.g. a bank) who has borrowed short-term in order to lend or invest long-term, that long-term investor may not be able to generate enough cash to repay the short-term loan. What ensues is either a forced or panicked liquidation of the long-term asset at a loss, or default on the short-term liability. Banks are the classic locus for mismatched maturities in most economies. If banks only had to finance commercial credit, which typically revolves in 30 to 90 days, then there would be little maturity risk. Banks would lend depositor money on a 30 to 90 day basis to firms that were borrowing operating capital to finance wages and input purchases, and firms would liquidate their liabilities as sales occurred and cash flowed in. But banks exist not only to provide short-term commercial credit, but also precisely in order to turn short-term liabilities (depositor money) into long-term assets (loans to homebuyers and industrial firms). This is what makes them vulnerable to bank runs.

All things being equal, bankers would prefer to avoid risk. In the absence of state efforts to overcome the risks from maturity mismatches, banks will limit either the volume of mortgage lending, or structure mortgage lending in ways that reduce maturity mismatch. Up until the 1930s, the typical bank strategy for avoiding mismatch involved large down payments (which discouraged all but the most serious and solvent borrowers) and short loan maturities (typically no more than five years, and often as short as three years). These were also often balloon loans, where the whole principal was due at once at the end of term. They thought this strategy would limit the risk of being unable to fund depositor redemptions. Even so, banks were leery of offering mortgages and as much as possible tried to fund those mortgages with different kinds of long-term deposits, typically by issuing their own bonds.
Short-term balloon mortgages had two consequences. First, they limited individual homeownership in urban areas. In the pre-1930s United States, roughly 40% of households owned their home. Given that roughly one-third of US households were farming, this implies quite limited urban ownership. Only families with stable incomes could risk borrowing, knowing that they would have to re-establish their creditworthiness within three to five years; only families with substantial incomes could accrue the 50 percent down payment banks required. Second, while balloon mortgages protected banks from individual defaults, they did not actually provide banks with protection in the event of a systemic shock like the Great Depression. The collapse of farmland and urban housing prices in the early 1930s provoked a vicious cycle of bank runs, property liquidation and falling prices for banks’ collateral assets, causing many banks to fail. While banker George Bailey\(^2\) can explain why rational people shouldn’t panic and run on their banks, avoiding bank runs is clearly a collective action problem and as such requires a state solution.

After the Great Depression, states everywhere stepped in to stabilize the banking system. Victory in World War II allowed the United States the opportunity to try to influence the choice of solutions, pushing countries towards longer-term, self-amortizing mortgages backed by parastatal finance agencies (De Grazia 2005). Most analyses of post-1930s state efforts to resolve this core maturity mismatch focus on depositor guarantees or insurance (Schwartz and Seabrooke 2009; Zimmermann 2013). These deposit guarantees calmed potentially panicky depositors, stabilizing the liability side of banks’ balance sheets. Some states also addressed the asset side of banks’ balance sheets by segmenting financial markets into long- and short-term credit markets, or by insuring mortgages against default. Insurance created an implicit bail-out guarantee for banks. Segmentation matched long-term assets to long-term liabilities at the level of specific financial institutions. This segmentation is what links private, indebted homeownership to (mostly private) funded pensions. Successful segmentation permitted the development of long-term mortgages like the classic American 30-year, self-amortizing, fixed-rate mortgage. In the absence of segmentation, this kind of mortgage would create intolerable maturity and interest rate mismatches for the banking industry.

The most elaborate form of segmentation is via securitization of mortgage debt, where banks sell mortgages off into the capital market, and where the buyers are typically insurance and pension funds looking to acquire long-term assets to balance their long-term liabilities to customers. Pension and insurance funds have stable and predictable long-term liabilities to their customers, particularly as rational consumers should opt to annuitize pension income. To fund these liabilities, pension funds need assets that generate a stable and predictable cash flow on the other side of their balance sheet. Mortgages provide that stable and predictable cash flow. Mortgages are not the only way to get stability, but they nevertheless account for a large proportion of pension assets everywhere. Figure 1 shows the relationship between the scale of mortgage debt and the scale of funded pension plans relative to GDP for the rich OECD countries. It suggests but does not demonstrate a close connection between the scale of mortgage debt and the size of funded pension plans.

**Figure 1: Mortgage debt versus funded pension assets, % GDP, 2009**

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\(^2\) See *It’s a Wonderful Life*, http://www.imdb.com/title/tt0038650/.
Segmentation and securitization could be accomplished in various ways that reflected the structure of political power at the time these institutions or regulations were birthed. For example, the Norwegian state provided the bulk of housing funds via a specialized state bank, Den Norske Stats Husbank, which had access to the public debt market, and the Japanese state channeled deposits from the huge postal savings system to the Housing Loan Corporation. In the United States, Fannie Mae borrowed from the capital markets in order to purchase mortgages from banks. But not all states did this. The Italian and Austrian states had no specific mechanisms, with the result that in the late 1970s over 70% of Italian housing finance came from personal savings, as did over 60 percent of housing finance in Austria (Boleat 1985: 218, 291). In between, Danish and German banks elaborated a system of covered bonds, which were funded by long-term deposits but remained on banks’ books with a bank guarantee to the bondholders. These specific institutional solutions thus varied in the degree to which they created liquid versus illiquid housing finance markets, where the crucial element creating liquidity was banks’ ability to generate mortgage finance without also generating a maturity mismatch.

Reality presents many composite systems varying along a continuum between the liquid and illiquid systems, but for analytic purposes it is worth considering the two ideal types at opposite ends of the spectrum. The first has large-scale, debt financed private homeownership and cheap rental housing, along with funded (largely private) pensions to hold the assets created by debt financed housing construction and purchases. The second has widespread debt-free homeownership, a limited private rental market, and, in the absence of a deep securities market to supply funded pension plans, pay-as-you-go (PAYGo) public pensions. Put simply, private pensions imply debt financed private homeownership and cheap rentals while public PAYGo pensions imply societies with illiquid housing markets, and vice versa. Pension and insurance systems face long-term commitments to their clients, and as noted above match this by acquiring long-term assets. Public PAYGo systems finance these commitments out of tax revenues. From a technical point of view, pension commitments via a PAYGo system are not strictly speaking liabilities. But the long-term commitments of private pension plans are de jure liabilities (commitments to pay money out), and, as such, they must be matched by long-term assets (claims on money coming in). Long-dated mortgages, or bonds built out of long-dated mortgages, or, a functional equivalent, rents from property directly owned by pension plans, create a natural asset for pension plans’ corresponding liabilities to their clients.
Liquid housing finance systems have extensive mechanisms for removing mortgage debt from banks’ balance sheets or for bypassing banks entirely. This can be done through forms of securitization or by having the state fund mortgages. Either way, mortgages tend to end up in the hands of pension funds (including funded pensions run by the state) and other long-term investors. By removing mortgage debt from banks’ books, states enable banks to expand lending to households for owner occupation and to developers for rental construction. This makes it easier for new households to attain homeownership. By contrast, in illiquid housing finance markets, banks have few mechanisms for avoiding maturity mismatch. Thus they generate little in the way of mortgage finance, and mortgages resemble the shorter term, balloon mortgages of the 1930s. This does not preclude high levels of homeownership, as Italy has higher rates of owner occupation than the United States or Netherlands. But the absence of some form of securitization means mortgage debt is very small in relation to GDP in Italy as compared to the United States or Netherlands (Figure 1).

On the other side of the balance sheet, a funded pension system cannot develop without a stable supply of long-term assets. In the immediate post-war period, equity markets were under-developed in almost all economies. This left bonds as the only source of long-term income for potential funded – usually private – pension plans. But what kind of bonds? Corporate bonds might substitute for household mortgage debt. But in the post-war environment few firms were able to independently float their own bonds. Most relied, instead, on revolving bank loans that de facto functioned as bonds, and which remained on banks’ balance sheets (think: German housebanks, or the main banks of Japanese keiretsu). Public debt might also provide an asset for pension funds, and indeed British and Dutch pension funds had a high proportion of public debt on their books until deregulation in the 1980s. Funded pension plans thus needed high levels of housing debt in order to function. These funded plans were not necessarily private, although most were. One public exception, the old Swedish public second tier pension, Allmän tilläggs pension, or ATP, was theoretically funded by employer payroll contributions. But these funds had to be parked somewhere, and as noted the Swedish state channeled them to the million home project (Miljöprogrammet), which aimed at building a million new housing units in a decade (Immergut and Anderson 2007:365). Municipalities and cooperatives borrowed money from the ATP, becoming the indebted landlords described above. Their ability to offer low rents depended on the ATP’s willingness to accept a lower rate of return and on state guarantees against default.

Where banks cannot securitize debt, they can still generate mortgages. As noted above they can reduce their maturity mismatch risks by limiting the volume of mortgages issued, by shortening loan terms, and by funding these mortgages with their own long-term bonds. Still, in the absence of an effective state solution to the maturity mismatch problem, funded plans are somewhat starved for assets to match their liabilities. Banks will not generate enough mortgage assets, leaving funded pension plans only public debt and equities as funding vehicles. But plans built on public debt might as well be run by the state as PAYGo systems, and in the post war years, the equity market capitalization in most countries was too small to sustain a fully funded pension system. Even by 2012, only 40 percent of OECD pension assets on a weighted basis were in equities, and this average was very much pulled up by the United States, which accounted for about half of global pension assets and where nearly 50 percent of pension assets were equities (OECD 2013:18). Funded pensions require assets to function, and if those assets are absent, then pension systems will be organized as PAYGo systems. No private firm will operate a PAYGo pension (nor will a rational individual accept one, if there is any more credible alternative), so countries with smaller mortgage markets typically have larger public PAYGo pension systems. This is what creates the apparent trade-off between housing and pensions. But it is in fact a trade-off between indebted homeownership and funded pensions on the one hand, and debt-free ownership and PAYGo on the other.
Thus the debate over the relationship between housing and the welfare state that occurred between Jim Kemeny and Francis Castles boils down to politics around a functional balance sheet reality. From a balance sheet perspective, the choice between owning and renting in Kemeny’s argument is a misreading, given that balance sheets must balance. Large-scale mortgage finance implies large-scale public or private holdings of mortgage bonds (or, less efficiently, of unbundled mortgages) whether or not those mortgages fund rentals or private homeownership. Debt free homeownership and a shortage of rentals implies a smaller pool of assets to fund pensions and thus a reliance on tax funded PAYGo pensions. This is why the countries in the lower left hand quadrant of Figure 1 often have higher levels of private homeownership and smaller rental markets than the highly indebted homeowners in the upper right hand quadrant; the countries in the lower left quadrant have smaller welfare states but large PAYGo pensions. Castles’ argument receives qualified support. Private homeownership certainly provides a substitute for a more robust public PAYGo pension, but it also supplies the robust pool of debt instruments that a private, second tier pension system needs in order to function. And just as voters with access to imputed rent might vote against larger public pensions, voters with access to private second tier pensions might also vote against an expanded public first tier pension.

*Figure 2: Two ideal typical relationships between housing finance and pension finance systems*

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
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<tbody>
<tr>
<td>Funded (private or public)</td>
<td>Widespread, debt financed</td>
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<td>pension plans</td>
<td>homeownership</td>
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<td>Cheap finance for cheap (or</td>
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<td></td>
<td>social) rentals</td>
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<td>Public tax financed PAYGO</td>
<td>Widespread debt free</td>
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<td>pensions</td>
<td>homeownership</td>
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<td>Limited rental market</td>
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The connection between debt financed housing and private pensions is a functional relationship, but the political history of housing finance sustains the integrity of the relationship, as Kenneth Snowden (2010) and Sarah Quinn (2010) both show with respect to the development of securitization in the United States. The Federal Home Owners’ Loan Corporation – Fannie Mae’s ancestor – refinanced roughly 1 million mortgages after 1933 by exchanging its bonds for mortgages on banks’ books. In doing so, it restructured housing finance away from shorter term (3 to 5 years), balloon payment, high down-payment, variable interest rate, interest only mortgages and towards the typical contemporary longer term, low down-payment, fixed rate, self-amortizing US mortgage. The US government took mortgages and thus the maturity mismatch off banks’ books. Initially the link occurred through straightforward government debt, albeit collateralized by houses. Eventually Fannie Mae financed its purchases directly through borrowing in capital markets, supplying its debt as a long-term asset for pension and insurance plans. Finally, Fannie developed the mortgage backed security (MBS), and began to turn itself into a pure servicer of mortgages on behalf of buyers of those residential MBS. Federal government interventions thus simultaneously created a new class of liquid, long-term assets that pension funds could buy, and removed mismatched maturities from banks’ balance sheets. By contrast, in Italy, there was virtually no formal mortgage finance system, with banks funding mortgages through small bond issues. As of 1981, 70% of housing finance was generated through private saving, largely channeled
through families, a situation which has not changed much in succeeding decades (Boleat 1985:218, 221; Allen, et al., 2004). Correspondingly, Italy had a large public PAYGo pension system. Similar stories could be told of other countries, but with considerable variation in the degree to which the banking system was able to shed its maturity mismatch.

Whether a country has a funded or PAYGo second tier pension system is thus tightly connected to the kind of housing finance system it has, and vice versa. Funded pensions require assets; home-buyer debt provides those assets. Without those assets, pensions are much more likely to be established on a PAYGo basis. There is no uni-directional causality here, because this is a balance sheet or reciprocal relationship. This is why quantitative tests, like those of Castles (1998) and of Conley and Gifford (2006) are unable to establish the direction of causality, although intensive case studies can tease out what might have been the primary concern of policymakers intervening in either mortgage or pension markets. It is also why the trade-off debate has been so hard to resolve. The initial debate focused on ownership, but the critical issue is the financing of ownership, not ownership per se. Similarly, the initial debate focused on public versus private pensions, but the critical issue is funded versus PAYGo. The near identity respectively between private/funded and public/PAYGo magnifies this confusion. That identity has political roots in the balance of class power. But even in the classic social democracies, funded pension plans require assets, as the privately organized (but mandatory) second tier Danish pension shows.

Conclusions and Implications for asset based welfare

In their analysis of the ownership-welfare debate, 3D produce a typology that leads them to criticize the idea that asset based welfare is possible in all societies with high levels of homeownership, and thus, by extension, that policies to increase homeownership might succeed in freeing the state from some of its social spending obligations while also giving individuals more control over how and when they need to rely on the state. 3D show that in de-commodified and pre-commodified housing markets, households simply cannot liquidate any of the monetary value locked up in the housing. Instead, it is precisely the use or consumption value of housing itself that is the resource. This is consistent with the findings of Allen, et al.’s (2004) larger study of southern European housing systems. 3D come to the correct, and pessimistic, conclusions about asset backed welfare not so much for wrong reasons as for incomplete reasons. Their typology shows why institutional configurations in some countries mean that housing (and perforce, pensions) are not in strict terms financial assets, and thus cannot be used to buffer households against life or economic events that cause income to drop.

As the analysis above shows, however, the difference between commodified and de-commodified housing and pension systems is not absolute. It reflects the degree to which banks transform mortgage debt into a marketable asset in order to remove maturity mismatches from their balance sheets. Liquid housing finance markets also create liquid home sale markets, and thus theoretically do enable people living in countries with liquid markets to use houses as a buffer against life and economic risk. Practically, of course, the covariance between income stability and size on the one hand, and financial and housing wealth on the other, means that many households will not be able to take advantage of this opportunity. Self-insurance remains an effective option only for those who face the lowest risks and thus need the least insurance.

What about the debate about the ‘big trade-off’ between homeownership and a robust welfare state or public pension? This debate has been inconclusive because the original terms of the debate mis-framed the actual trade-off. Mis-framing means that most of the participants in the debate end up being right for the wrong reason. The trade off is not between homeownership per se and welfare or public pensions per se. The trade-off, to the extent that it exists, does not arise because purchasing a home necessarily involves substantially more front-loading of costs than does renting. Nonetheless, Kemeny is
correct that the balance between homeownership and renting is politically determined through a wide range of subsidies to housing. States do control the form of tenure that predominates in their housing markets. Castles is correct that freehold ownership does mean that retired households can enjoy a higher standard of living than their overt cash income would otherwise permit. But this does not determine the size of public pensions. States can make second tier, privately funded pensions both mandatory and adequate as in Australia and Denmark, and also somewhat egalitarian, as in Denmark. These are reasonable substitutes for a public second tier pension, albeit with different distributional consequences.

The trade-off is not dichotomous, or as 3D would have it, an artifact or spurious correlation arising from a confusion over what homeownership means financially for households. Rather, the trade-off occurs because of the combination of a balance sheet reality and political responses to that reality. When households buy housing using debt, this liability has to appear on banks’ balance sheets as an asset. At the same time, banks must incur a liability to depositors in order to fund that purchase. In the absence of state intervention to reshape financial markets in general, and housing finance in particular, the risk of mismatched maturities on banks’ balance sheets will incentivize them to limit mortgage lending. In turn this limits the volume of assets available for a funded pension system. The more that states intervene to remove maturity risks from banks’ balance sheets, or to protect specialized housing banks from risk, the greater the pool of assets available for private pension schemes. This trade-off produces a continuum of relatively more or less commoditized housing and pension systems in which mortgage debt and pension assets are only loosely coupled, but nonetheless coupled.

This functional relationship does not determine how societies choose to resolve the maturity mismatch, nor whether their pension systems are public or private, nor whether renting or ownership dominate housing tenure. All of these are fully political choices. But the choice is made from a menu in which it is very hard to create large funded pensions without some recourse to mortgage debt and very hard to generate large volumes of mortgage debt in the absence of a ready buyer of that debt. That is the big trade-off.

References:


