



# Neighborhood externality risk and the homeownership status of properties

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## Abstract

In contrast to corporate and institutional investors, single owner-occupiers cannot adequately diversify housing investment risk. Consequently, homeownership should be relatively less likely in places with higher housing investment risk. Using the American Housing Survey, it is documented that neighborhood externality risk, a major component of housing investment risk, substantially reduces the probability that a housing unit is owner-occupied, even when controlling for housing type and numerous location and household specific characteristics. The effects are quantitatively meaningful and change-in-change estimates suggest that the effects are causal.

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## 1. Introduction

Changes in neighborhood amenities can have considerable effects on house prices. Moreover, the likelihood of such changes can vary significantly between neighborhoods. Neighborhood uncertainty is therefore associated with substantial neighborhood specific housing investment risk. This simple observation raises important questions. Do potential

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homebuyers take into account the risk of changes in neighborhood amenities when they decide in which neighborhood to invest? Does neighborhood specific risk thereby affect the probability that a property is owner-occupied? This paper addresses these questions. Specifically, it examines whether neighborhood externality risk variables, directly measured as the standard deviations of four types of neighborhood externalities—junk and litter in the neighborhood, street noise, neighborhood noise, and neighborhood crime—between 1985 and 1999, negatively affect the likelihood that a specific housing unit is owner-occupied. Moreover, the paper investigates whether *changes* in the risk measures over time affect the likelihood of a *change* in the homeownership status of properties.<sup>1</sup>

The paper also examines the importance of neighborhood uncertainty for the low homeownership rates in inner cities. Inner cities typically have greater neighborhood uncertainty compared to suburban and rural places.<sup>2</sup> Inner cities also generally have a more poorly maintained housing stock, lack of social capital, substantial juvenile crime problems, and low quality schools. Interestingly enough, recent research links these inner city problems to low homeownership rates. For example, Galster [12] suggests that due to moral hazard problems tenants treat their units less carefully than homeowners. Rossi and Weber [41] and DiPasquale and Glaeser [4] suggest that homeownership benefits social capital. Green and White [14] show that homeownership provides a better environment for the upbringing of children. Hilber and Mayer [24] show that the positive correlation between land scarcity and school spending persists only in places with high homeownership rates. Finally, Fischel [8] suggests that places with high homeownership rates may also have better control over local government. Because of these findings, a better understanding of the causes of the low homeownership rates of inner cities should be developed.<sup>3</sup>

The previous housing literature has mainly focused on household specific characteristics as determinants of the individual tenure choice.<sup>4</sup> Yet, research about the role of location specific factors as determinants of the homeownership status of *properties* is a widely underdeveloped area. The user cost literature (e.g., Rosen [39], Hendershott [20], Hendershott and Slemrod [21], Poterba [36]) argues that lower user cost of housing is ex-

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<sup>1</sup> Homeownership status is defined as the tenure status of a property, which is either 1 for owner-occupied units or 0 for renter-occupied units.

<sup>2</sup> An analysis of the American Housing Survey for 1985 and 1999 indicates that center city locations and neighborhood externality risk measures are positively related. A similar link between inner cities and housing investment risk was suggested by Rachlis and Yezer [37]. They estimate real estate investment risk as the variance of the errors in an appraisal equation and show that such appraisal risk is related to inner city locations.

<sup>3</sup> The phenomenon of particularly low homeownership rates in inner cities can be partially explained by segregation of households with different characteristics. Segregated groups may have different income or wealth and may be differently affected by federal tax laws, borrowing constraints, or racial discrimination in capital markets. Furthermore, the households of different segregated groups may differ in their life-cycle attributes and in their uncertainty about future income. However, all these determinants fail to fully explain why homeownership rates are so extremely low in inner cities and thus the literature often has to rely on the argument that households that prefer center city places also have some intrinsic preferences for renter-occupation.

<sup>4</sup> It is now widely recognized that factors such as basic demographic variables (e.g., Eilbott and Binkowski [6], Gyourko and Linneman [16]), borrowing constraints (Linneman and Wachter [30]), race (e.g., Kain and Quigley [27], Gyourko et al. [17], Painter et al. [35]), expected length of stay (e.g., Haurin and Gill [19]), and taxes (e.g., Rosen [39]) are major determinants of the individual housing tenure choice (i.e., the decision of households whether to own or rent the home).

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