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Owning Beats Renting, in the Long Run

by

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If you bought a house in Los Angeles in the early 1990s, you were catching a falling knife.

Home values were falling. Thousands of buyers in that period spent most of the decade upside down – owing more than their house was worth.

Today, whatever the angst about the current market, all those knife catchers are sitting pretty. The upside-down years are a distant memory.

I thought about that as I read reader responses to a recent column that took a long-term, consumption-smoothing approach to the purchase of a pricey San Diego house. The exercise showed that buying such a house can be beneficial even if real estate values fall – provided the buyer lives in the house for a very long time.

Even in areas where the monthly cost of owning is a big premium over the cost of renting, a long-term approach still showed that owning produced a higher lifetime standard of living than renting.

Reader reactions ranged from suggestions that I had lost my mind to, well, howls of excoriation. So this may be a good time to remind ourselves of the one simple reason homeownership has done so much for so many.

Longtime owners

Whatever the current market, it remains that people who intend to be in their homes 15, 20 and 30 years from now will do just fine.

This won't happen because of generous tax breaks. Wild appreciation would make things better, but it isn't necessary.

This happens because owning a house is the easiest way to make inflation work for you rather than against you.

Suppose, for example, that you are a young family thinking about buying a house in Lewisville. There, you can find relatively new houses of about 2,000 square feet with three or four bedrooms, two baths and a two-car garage for about \$150,000.

The terms

If you bought such a house with a 20 percent down payment and a 30-year mortgage at 6 percent, it would cost \$8,634 a year for the mortgage and about \$7,500 a year for taxes, insurance and upkeep (based on 5 percent of market value). The total out-of-pocket cost would be \$16,134 a year.

Long term, this would put you way ahead of a renter, even though the same house could probably be rented now for about \$15,000 a year, or \$1,250 a month.

How can this be?

It isn't because of your fantastic tax deductions. They may help the people in Boston and San Diego to buy pricey condos, but they don't do anything for people with average incomes in most of the country.

Instead the benefit comes from the decline in the real cost of the mortgage. Even modest inflation will cut the effective cost of the mortgage dramatically over 30 years. And then the cost disappears. The renter, meanwhile, faces a lifetime of rising rent bills.

If inflation runs at 3 percent a year, the operating costs of the house will remain at \$7,500 in real terms five, 10 and 20 years later. Ditto the \$15,000 cost of a comparable rental: It will still be \$15,000 in current dollars.

The cost of the mortgage, however, will be \$7,643 in five years, \$6,563 in 10 years, \$4,840 in 20 years and \$3,569 in 30 years when measured in real dollars. After that, it will be zero.

The homeowners' cost is lower than the renters' in the sixth year of ownership. The homeowners' cumulative cost is lower than the renters' in the 11th year. After that, it's all gravy for the homeowner.

Of course, in real life the actual numbers will differ. But as long as inflation whittles away the purchasing power of the mortgage payment, the odds will favor the homeowner over the renter.

Note that home appreciation has not been mentioned.

Even if the value of the house doesn't rise, the benefits compete very well with the return a renter could get by investing what he would have spent on a down payment. The homeowner will pay the mortgage off in 30 years, bringing his equity to \$150,000. For the renter, the down payment would have to return 4.2 percent, after taxes, to accumulate to the \$150,000 value of the home after 30 years.

Again, that's assuming no home price appreciation.

Retirement payoff

What does this mean for lifetime consumption other than shelter? For a couple with \$60,000 a year of income, owning provides only a small advantage while they are working – but it provides a major improvement in retirement.

ESPlanner consumption-smoothing software shows that while the renter and owner would both have after-tax, after-shelter consumption of just over \$36,000 a year while working, the homeowners would enjoy a bump up to \$44,612 a year in retirement, an improvement of about 24 percent over the renters.

Does this mean we can spend carelessly on houses?

Sorry, no.

It means inflation will protect us from all but the worst housing markets, if we give it enough time.