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The Impact of Transaction Costs and the Expected Length of Stay on Homeownership[1]

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Economic theory suggests that an increase in the expected length of stay in a dwelling increases the probability of a household choosing to own a house rather than rent. This hypothesis is derived from recognition that there are substantial transaction costs associated with homeownership and increased expected time in the home reduces the annualized transaction cost. Using a military data set, we confirm that expected length of stay in a dwelling and the transaction costs of selling are very important to the ownership decision. Our best estimate of the transaction costs of selling a home are the sum of 3% of house value and 4% of household earnings.

I. INTRODUCTION

Recent increases in the aggregate rate of homeownership has renewed interest in determining the factors that influence a household's tendency to own rather than rent [45, Table 27]. There is substantial interest in determining the future course of housing demand and the effects of existing and proposed housing policies. There is also substantial interest in the prospects of homeownership for low income and minority households.

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Our study of the determinants of homeownership focuses on two factors that have received relatively little attention in the literature: transaction costs and a household's planned duration of stay in a dwelling. Economic factors typically hypothesized to be important to the tenure choice decision include a household's real income and wealth, the price of owning compared with renting, and mortgage lender requirements. Although both transaction costs and planned stay have been hypothesized as being important to tenure choice, prior empirical work has omitted these factors or has been plagued by measurement error. Further, sorting out the reciprocal impact of decisions about ownership and the duration of stay has been difficult. Through the use of a new data set and the unique employment situation of the respondents in our military sample, we are able to substantially overcome these problems and show that transaction costs are important to the tenure choice decision.

Many researchers have explicitly or implicitly ignored the transaction costs of selling a home when determining the cost of homeownership; however, such costs are not trivial. Most easily measurable is the real estate broker's fee, often 5 to 7% of the sale price of the house in the United States. Other costs include the implicit cost of maintaining the house in showroom condition during the time when it is on the market, the lengthier search process for homeowners compared with renters, transfer taxes, and legal fees (Linneman [34]). Also, there is the risk of bearing the cost of simultaneously owning two houses in two localities or delaying the purchase of a new house while attempting to sell the current house. Once the transaction costs of homeowning are recognized, the expected length of stay in the home becomes a key variable in determining the expected annualized cost of owning. Besides the transaction cost of selling a home, other costs are incurred when homeowners relocate including the loss of attachment to a neighborhood, the loss of information about local private and public services, and the possible loss of benefits associated with a mortgage interest rate that is lower than the current market rate. Although important, our data do not permit us to estimate the size of these costs.

Measuring the size of transaction costs associated with homeowning is important for a number of research questions involving the housing market other than the tenure choice decision. Linneman [34] needed an estimate of transaction costs to study housing market efficiency. Both Venti and Wise [46] and Weinberg *et al.* [47] study renters who participated in the Housing Allowance Demand Experiment. These researchers needed an estimate of transaction costs to study respondents' residential mobility and whether the market was in equilibrium. Transaction costs are an important component of intertemporal housing adjustment models (Harmon and Potepan [20], Edin and Englund [11]), and an exact estimate is needed for simulations of these models (Ioannides and Kan [30]). For example, Goodman [16] assumes the transaction costs for a relocating homeowner are 5 to 10% of current income. The transaction cost associated with selling a home is key to the explanation of why