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For the Past 30 Years, Renting Was Generally Better Than Buying

By Daniel Indiviglio

If homeownership is the American dream, then the nation had better wake up. That's the message from a new research paper that examines whether buying or renting a home was a better financial decision over the past 30 years. Most would find the result surprising: over the period Americans were better off renting between 65% and 75% of the time, depending on the investment alternative.

The article by Eli Beracha (East Carolina University) and Ken H. Johnson (Florida International University) essentially looks at eight-year periods and assumes that a person invests the money he or she saves by renting. Since buying is generally more expensive than renting, renters have extra money to invest. It also makes a number of assumptions favorable to homeownership, including gains from the mortgage interest tax deduction, the option to refinance, and the ability to walk away -- loss-free -- from an underwater mortgage. Still, renting wins approximately three-quarters of the time.

The staff at economic research organization e21 explains why this result actually shouldn't be so shocking:

> Counterintuitive as the finding may be to some, it is actually quite logical. Unless someone possesses the cash necessary to buy a residence, he or she will be renting one way or another. The choice is between renting the property directly or instead renting the capital necessary to buy the property. The amount of capital to be rented is a function of house prices, while the bulk of a mortgage payment is interest, which is the rental payment on this capital. After 2 years, the typical 30-year amortizing mortgage balance has been reduced by less than 3%. This means that a household that took out a $300,000 mortgage with a 5% interest rate to buy a home has only reduced its mortgage balance by $8,600 after two years despite spending nearly $39,000 in total over this period.
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> Housing advocates may respond by pointing out that at least the $8,600 in this scenario went towards home equity rather than simply being squandered on rent. But, as demonstrated in the Real Estate Economics article, the principal component of each mortgage payment - i.e. the

> portion of the mortgage payment that goes towards reducing the principal mortgage balance instead of interest - is an added expense renters don't have.

This turns the real estate industry's biggest talking point on its head: you aren't throwing rent into the wind each month, you're casting away equity.

Of course, that equity also provides a potential benefit. The analysis's eight-year rolling methodology appears to miss the biggest reward of owning a home: living rent-free once the home is paid off. After that 30-years is up, the longer a family remains in that home rent-free, the more buying pays off. Taking this into account would almost certainly change the result in some, if not all situations. Renting may be a better option initially, but there's no eventual reward.

An important point still needs to be made here: buying a home that you don't plan to live in for an extended period of time probably isn't a great idea. The rent you pay in the form of interest on a 30-year loan for five or even 10 years won't be any better than if you had just rented outright. But if you're planning on living in a home for 30-plus years, then you could potentially get some benefit from buying rather than renting.

Read the full stories at the Financial Management Association (paper) and e21 (commentary).

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