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The Pros and Cons of Housing Market Investors

Are investors bad for the housing market?
And if so, how should policymakers address this problem?

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Housing is of utmost importance to the economy at both the micro and macroeconomic scales. On the micro scale, the typical American household's largest asset is their home, and the majority of properties are lived in by their owners. (That is, they are "owner occupied," and their owners are "owner-occupants.") On the macro scale, housing market fluctuations can wreak havoc on the nation's financial stability. Housing's importance at both scales is highlighted by two recent episodes: the boom and bust leading up to the Great Recession and, later, the pandemic runup in housing prices. Both episodes affected almost everyone—and both raised concerns among policymakers about housing market investors' (HMIs') increasing presence in this market. Houses are intended to shelter people, and some worry that physically absent, financially

motivated owners may harm the homes' occupants, by either extracting excessive rents or destabilizing markets.

So, should policymakers restrict HMIs? For example, should policymakers impose a transaction tax that discourages the trading of properties? Or should they police investors through the mortgage market by making it harder for them to borrow money to buy a house they don't intend to live in?

First, we need to find out whether HMIs are good or bad for the housing market. In reality, there are few bright-line distinctions between "good" and "bad" HMIs. In many cases, being a "good" or "bad" investor depends on the investor's particular actions rather than their status as a nonoccupant (that is, one who does not live in the property they own). Although there are legitimate concerns about certain investors

Who or What Is an HMI?

The academic literature and trade press use varying definitions and categorizations of “housing market investors.” In this article, I define an HMI as someone who owns a property for its financial return and not for their own use. This definition differentiates an HMI from an owner-occupant and also ignores vacation homes (which are not regularly occupied but are held for the use of the owner). In some cases, the HMI’s property will be rented out, making the HMI a landlord, and the financial return is a cash flow of rental payments from the home’s occupant. In other cases, the HMI’s property will be held vacant, possibly while undergoing renovation, with the HMI intending to resell the property for a capital gain. Under the broad heading of “HMIs,” different motives, strategies, and behaviors lead to different implications for market stability and welfare.

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speculating on homes, and thereby exacerbating cycles and driving out owner-occupants, there are also many ways HMIs can improve welfare. For example, HMIs may provide liquidity in a downturn; improve matching efficiency between buyers and sellers by “market-making”; and return idle, foreclosed homes to the market in the form of rental properties.

Some HMIs Destabilize

Some HMIs have speculative motives: They buy homes exclusively for the purpose of gaining from their resale, not for renting to other occupants (and not for themselves to live in).¹ An owner-occupant may be tied to a home because of its fit for their household composition or because of their neighborhood attachment. But HMIs, being driven by financial motives, are more likely to react to short-term changes in the price of a home. This means that their reactions to even slight changes in the housing market can amplify price movements. If they believe housing prices are about to increase, the market may be flooded by speculative buyers, intensifying price growth and hurting affordability. But if they believe prices are about to decrease, speculative owners may rapidly sell their properties, cratering prices and undermining the wealth of owner-occupants.

There is empirical evidence that speculator HMIs are active in housing booms. (Later in this article, I discuss whether such HMIs cause housing booms.) Using housing transaction and listing data for the U.S. in the 2000s, economists Anthony DeFusco and Charles Nathanson of Northwestern University and Eric Zwick of the University of Chicago show that buyers who do not expect to own their properties for long—and especially if they do not intend to live in their properties—are more active during housing booms.² They find that speculators were most active in housing markets in which cycles were especially volatile, such as Phoenix and Las Vegas (Figure 1). Many of these buyers bought late in the cycle, listing properties for sale after the transaction volume and prices had begun to decline.

Further empirical evidence suggests that many of these speculative investors are novices. Duke University economists

Patrick Bayer, Christopher Geissler, and James Roberts and I show that new, inexperienced investors often enter the market during price booms.³ Some can earn high gross profits if they accurately predict price increases, but some are left with properties purchased at the peak. In separate research, Bayer, Roberts, and I show that new investors are more likely to enter the market if they see other investors active in their own residential neighborhoods.⁴ These influenced investors tend to fare worse even than investors with comparably little experience.

But does activity by speculators cause the boom-bust cycle? DeFusco, Nathanson, and Zwick say “yes.” They built a model of housing market dynamics featuring buyers with differing motives for purchasing and with different holding tenures, all with limited information about the fundamental demand for property in the market. Theoretically, if HMIs were highly sophisticated and well informed, they would accurately predict future prices. However, because the model’s HMIs lack adequate information, they rely on recent price trends to predict future prices. Thus, if prices have recently increased, HMIs predict that prices will continue to rise throughout the time they expect to own their property. That can lead to destabilization, with HMIs buying while prices are increasing, irrespective of what the market is signaling about a property’s true value. Some HMIs may thus end up holding on to properties well past their market peak, which exacerbates volatility if HMIs then decide to sell their properties all at once. And that is precisely what DeFusco, Nathanson, and Zwick find had happened in many real-world U.S. housing markets during the housing boom and bust surrounding the Great Financial Crisis.

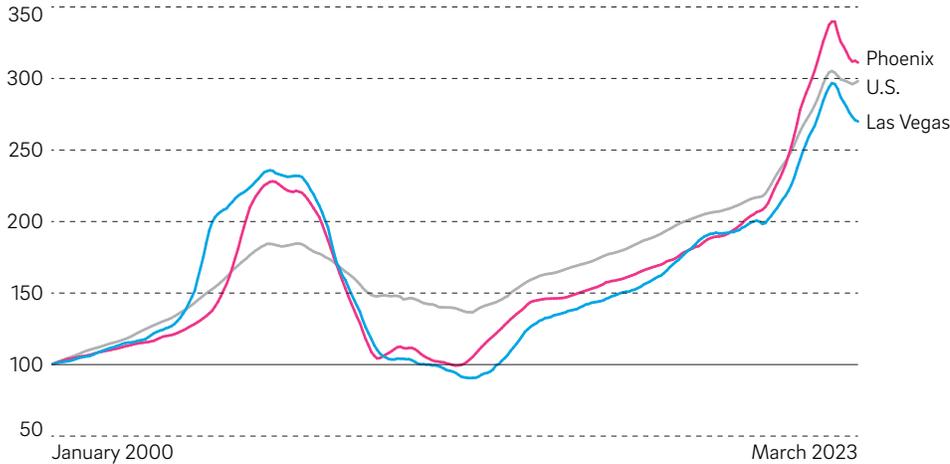
Based on these findings, I conclude that if we want to develop a theory of how investors destabilize housing markets, we need to consider information quality and investor sophistication in addition to HMIs’ financial motivations.⁵ A model of the economy in which everyone acts rationally does not exhibit the same boom-bust dynamics, even when HMIs are present. Limited information and extrapolation—that is, the use of the recent past to predict the future—are important features of the housing market. And they are made

FIGURE 1

Speculators Were Most Active in Volatile Markets

Phoenix and Las Vegas were particularly volatile.

Housing price index, 2000=100



Source: S&P/Case-Shiller Home Price Index.



By 2010, new construction had halted as prices collapsed in Las Vegas. TREKANDSHOOT/ISTOCK



Phoenix's growth also slowed as prices slumped, but then later resumed. PHOTOVS/ISTOCK

even more relevant by the presence of so many investors who are market novices.⁶

These theoretical results are corroborated by empirical research that isolates causality thanks to a statistical technique called instrumental variables. Because it is not clear what comes first, price increases or investor entry, researchers use variation in instrumental variables, or factors that exist outside a local housing market but have an indirect effect on it, to predict the market entry of various types of investors. For example, researchers have used economic shocks in distant locations to predict out-of-town buyers;⁷ the prevalence of vacation properties in a market's distant history to predict second-home buying;⁸ and state-level variation in capital gains taxes to predict the entry of speculative HMIs.⁹ In each case, the results indicate that investor activity exacerbated local price cycles.

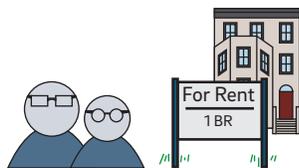
Some HMIs Stabilize

Just because all HMIs have financial motives for buying properties does not mean that they all destabilize the housing market. Yes, speculators tend to “chase” trends in the market, amplifying market volatility and leaving them overexposed when the market inevitably crashes. But other HMIs are neither speculators nor novices.

Some HMIs, for example, are landlords, who earn returns by renting their properties rather than from capital gains, and so are likely less vulnerable to the price fluctuations that speculators watch so closely. Recent research has found that landlords became more active in purchasing during the market downturn following the Great Financial Crisis, stabilizing prices by setting a floor for demand.¹⁰

Other HMIs earn a capital gain not by speculating but rather by functioning as a market-making “dealer”: They buy distressed properties from eager sellers and return the homes to market relatively quickly. As Bayer, Geissler, Roberts, and I note, speculators buy infrequently and tend to hold their properties longer (often for one to two years) before reselling them. Middlemen, however, frequently buy properties at a discount and quickly resell them (usually in less than a year, and often in just a few months). These investors are “middlemen” because they

The welfare implications of an investor's activity thus depend on the type, behavior, and strategy of the investor.



Landlords



Middlemen



Speculators

create a market where none previously existed. The middleman makes a profit not by selling when the market is “hot,” but rather by buying from a property owner so eager to sell, they are willing to accept a price cut.

Both landlords and middlemen tend to stabilize housing markets. Notably, the activities of these more experienced, higher-volume HMIs are countercyclical: They buy in periods of lower demand. This is in accord with their apparent strategy, which is to buy properties when the sales price is declining, not during exuberant hot markets. In doing so, they provide a counterweight to fluctuating demand for housing and protect home prices from intense market swings.

HMIs' Effects on Welfare

Some HMIs benefit noninvestors, while others harm them.

For example, Bayer, Geissler, Roberts, and I, as well as, separately, economist Philippe Bracke of the UK Financial Conduct Authority, find that investors pay less than the expected market value for the properties they acquire.¹¹ This suggests that, upon resale, investors may be making a profit that might have otherwise been a surplus for buyers and sellers who live in these homes.¹² Moreover, recent work indicates that HMIs make housing less affordable by disproportionately increasing prices of the cheaper properties that function as “starter homes” for first-time homebuyers.¹³

On the other hand, intermediaries can improve the matching efficiency in the market. In this scenario, a purchase discount is evidence that the HMI is buying from an urgent seller. Unlike the seller, this more patient HMI can wait for a buyer willing to spend more for the home. This would improve the match quality—and the seller would make more money from the transaction—while the buyer would be able to buy the home they want at a price that reflects the reality of the local housing market.

In addition to matching efficiency, certain HMIs can affect welfare through the capacity utilization of housing. An occupied house is delivering housing services. But if a house is lying vacant—either because it is held up in a foreclosure

proceeding or because a speculative owner is trying to time the market—it is a wasted resource, and no one is benefiting from the property’s housing service. If HMIs buy foreclosed homes held idle by financial institutions and return the properties to market, they help deliver housing services to (new) occupants.

Thus, the welfare implications of an HMI’s activity depend on the type, behavior, and strategy of the HMI. My work with Bayer, Geissler, and Roberts indicates that speculators likely harm societal welfare. Even aside from the possible destabilizing effects of their activity, the loss of property utilization to speculation is probably significant. Middlemen, unlike speculators, likely have a neutral to a positive effect on welfare, because the properties they purchase are not vacant for long and because they help match those properties with buyers. Moreover, property “flippers” often make physical improvements to their properties, restoring viable housing stock in housing markets suffering from a lack of investment. In short, more people use and benefit from properties when HMIs purchase distressed properties and return them to market. In areas where investors are more active, there are fewer vacant properties, and properties spend less time in foreclosure.¹⁴

How Policy Could Address HMIs

The complex nature of HMIs creates challenges for policy design. As we have seen, HMIs do not necessarily destabilize the housing market, and some HMI activity may actually make the market work better for everyone. Admittedly, it is unambiguously bad when speculators leave homes idle. But a restriction on HMIs could discourage market-making, liquidity-providing, and demand-stabilizing investors. And besides, restricting all housing transactions may burden owner-occupants more than HMIs. So, rather than limiting all HMI buying, policymakers may want to target the socially less-desirable HMI activities. But it is challenging to design such a precise policy.

One proposed policy is a Tobin tax, which levies a “round trip” transfer tax on the prices paid at purchase and sale.¹⁵ Originally suggested for currency trades,

the policy is simple and clear, and it discourages quick and frequent flipping of properties. But it also taxes “good” transactions among owner-occupants, landlords, and middlemen. This is where it matters that housing is a real consumption good, not just a financial instrument.

Hence, transfer taxes like the Tobin tax may have perverse effects, as found by economists Lu Han of the University of Wisconsin at Madison and L. Rachel Ngai and Kevin Sheedy of the London School of Economics, who studied Toronto’s Land Transfer Tax (LTT). By comparing transactions in the City of Toronto to transactions in the greater Toronto area, they found that the LTT reduced the percentage of homes occupied by their owners and increased the number of landlords. The authors reason that because the LTT discouraged frequent house trading, households with a shorter expected tenure in their homes opted to rent instead of buy and sell.¹⁶ This also leads to an overall decline in liquidity, with households moving less frequently and homes for sale spending more time on the market. Overall, the distortions of this transfer tax have led to substantial welfare losses, especially for owner-occupants.

A transfer tax could be designed to target specific investors, but doing so requires a way to define the investor before they buy the property. Take, for example, the Taiwanese housing market, which for several years levied a housing transfer tax based on how long the owner owned the property. Under this graduated tax regime, the tax, which was paid by the seller at the point of sale, declined after one year of property ownership and then dropped to zero at two years. Investors responded predictably: They held homes for two years and then sold them all at once, avoiding the tax altogether.¹⁷

There are alternative taxes. Like transfer taxes, capital gains taxes discourage speculation. By basing a capital gains tax on the length of the holding period, policymakers could avoid taxing (most) owner-occupants. (The sharp graduation of taxes in the Taiwanese market remains a cautionary tale.) However, capital gains taxes also tax property dealers and thus limit their market-making function. This is relevant to middlemen because they tend to buy at a discount and

earn their returns from the individual property’s rapid capital gain, not from marketwide appreciation. Moreover, HMIS often invest in their properties during the holding period, and a capital gains tax would have to deduct the cost of these physical improvements. Otherwise, the tax would discourage property owners from improving their properties. Accounting for all revenues and deductions would effectively turn each instance of a property flip into something more like a business tax return, meaning that the application

exemption.”) However, there are practical challenges here, too. Disparate property taxes would have to avoid taxing landlords. Otherwise, landlords would likely pass the tax on to renters. To avoid taxing owner-occupants and landlords, the property tax would have to be on a vacant house the current owner never lived in—a condition that may be difficult to enforce.

Policymakers could instead focus on how investors finance their purchases. For example, a policy could target the price an HMI pays for a mortgage. This already

Rather than limiting all investor buying, policymakers may want to target the socially less-desirable activities of housing market investors.

of this tax instrument would be very complicated in practice.

To target the underutilization of housing, local governments could use property taxes rather than transactions taxes. This would discourage the holding (but not the trading) of properties. Moreover, property taxes are well established in most American communities, and it is politically and practically easier to use a preexisting tool rather than introduce a new one. (Some communities already apply a lower tax rate to properties owned by their occupants, often through a “homestead

occurs to some extent. Homeownership enjoys tax benefits, including the mortgage interest deduction, which benefits owners who use their properties themselves.¹⁸ In the mortgage market, private lenders compensate for the increased risk of default by charging owners who don’t live in their properties a higher interest rate.

Policymakers could expand this spread. They could even have different spreads for rented properties, vacant properties, and properties that are being renovated. An extreme policy would ban any financing of investment properties.



Speculative investors have driven a boom in condominium construction in Toronto. BENEDEK/ISTOCK

Policies that target how investors finance their purchases may seem like an oblique instrument compared with, say, transfer taxes. However, implicitly “taxing” HMIs’ activity through the financing channel has several attractive features. First, it taxes the more financially destabilizing investor. When loans are cheap and easy to acquire, investors can more easily speculate with borrowed money. Increasing the cost of holding a property (though not necessarily the cost of acquiring it) would counteract this tendency. Second, it taxes the speculator HMI more than the middleman. The dollar cost of a mortgage tax would increase while the property is being held, discouraging idle property holding. Also, the cost is thus proportional to the purchase price. Because experienced middlemen tend to buy at a steeper discount, they can reduce their exposure to this policy. Third, although the total mortgage tax increases with each month the property is held, it is unrelated to the eventual sales price. This would discourage speculators from holding out for a higher sales price, reducing the length of time that properties remain vacant and smoothing the boom-bust dynamics characterized by DeFusco, Nathanson, and Zwick.

However, there are challenges to implementing such a proposal. Unlike a simple transfer tax, no level of government directly controls mortgage rates. Any mortgage tax would have to be enforced through financial policy, perhaps through the Federal Housing Finance Administration’s oversight of government-sponsored enterprises (such as Fannie Mae). Also, unlike a transfer tax, which can be controlled by municipalities, an effective mortgage tax would have to be implemented at the federal level, making it harder to tailor the tax to local market conditions. It also may be harder to enact, because a federal policy would require political support from a wide constituency. Furthermore, even in the private mortgage market as it stands now, occupancy misreporting is already rampant: To avoid the nonoccupant mortgage price, many HMIs (falsely) declare on their mortgage

applications that they intend to live in the property, secure in the knowledge that no one will follow up on their claim.¹⁹ Without stricter enforcement of existing rules, an additional mortgage tax on HMIs would presumably exacerbate the problem of misreporting. Finally, a policy would have to target the specific behavior of the “bad” investor without giving the investor a way to avoid the tax. Currently, there is scant literature about how investors use and interact with the financial system, making this a welcome area for further research.

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A problem inherent in any of the above proposals is how to identify which homebuyers are HMIs. As evidenced by occupancy misreporting, many buyers are unlikely to state their intentions up front, to their financial detriment, unless forced to do so. It would

be costly to verify whether a property is occupied by the owner, rented to another occupant, or left vacant. Besides, an investor’s objectives may change while they own a property. For example, an HMI may intend to speculate on the home at the time of purchase but ultimately rent it to tenants. Finally, the composition of the types of investors that participate in the market can vary in unforeseeable ways across time and business cycles. Much of the recent literature on housing investors has shown that the post-Great Recession HMI is more likely an institution than an individual. These institutions probably have deeper pockets and greater financial sophistication, though perhaps inferior knowledge of the local housing market. No one could have foreseen this development before the Great Recession.

Hence, the policies discussed in this article target types of investors by policing behaviors consistent with the type. This is why we need to understand and document the behaviors of HMIs. Specifically, we need to identify behaviors that destabilize the housing market or damage societal welfare and that might respond to policy. Policy will be more successful and easier to implement if it focuses on specific behaviors and does not lump all investors together. ■

Notes

1 Gao, Sockin, and Xiong (2020) say that such HMIs are a “nonfundamental source of demand.”

2 DeFusco, Nathanson, and Zwick (2022).

3 Bayer, Geissler, Mangum, and Roberts (2020).

4 Bayer, Mangum, and Roberts (2021).

5 See Scheinkman and Xiong (2003).

6 See Glaeser and Nathanson (2017).

7 See Chinco and Mayer (2016).

8 See Garcia (2022).

9 See Gao, Sockin, and Xiong (2020).

10 See Mills, Malloy, and Zarutskie (2019) and Lambie-Hanson, Li, and Slonkosky (2022).

11 Bayer, Geissler, Mangum, and Roberts (2020) and Bracke (2021).

12 This does not imply that the total surplus—the size of the pie—of a transfer from seller to buyer is reduced, only that the intermediary took some of the pie. Note that a buyer can earn a surplus by purchasing for a price less than their innate value of the property.

13 See Garriga, Gete, and Tsouderou (forthcoming).

14 See Lambie-Hanson, Li, and Slonkosky (2022).

15 Most jurisdictions in the U.S. have some form of a tax on deed transfers. At issue is whether such taxes discourage investor behavior and thus can be used as a policy instrument to affect investor participation in the market. Moreover, transfer taxes can be disproportionately levied on investors. For example, Ontario, Canada, imposes a Non-Resident Speculation Tax on properties purchased by foreign buyers.

16 Han, Ngai, and Sheedy (2022).

17 See Chi, LaPointe, and Lin (2022).

18 The mortgage interest deduction extends to second homes (as in, vacation properties) but not the investor-owned properties that are the focus of this article. The maximum deduction at the tax-return level is \$750,000, meaning that the sum of the first and second home mortgage interest payments count as a single deduction.

19 See Griffin and Maturana (2016) and Elul, Payne, and Tilson (2023).

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