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Research BRIEF

What Happens To Household Formation In A Recession?

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The present economic downturn has been, by many measures, the most severe since the Great Depression. The housing market has been hammered by large declines in real house prices, caused in part by the collapse of the housing finance system and by continued job losses. While the difficulties in the housing market affect the entire country, some areas (Arizona, Florida, Nevada, and California) have experienced much steeper declines in home prices and overall housing market activity. The national homeownership rate has declined from a peak above 69 percent to just over 67 percent, with homeownership rates for some minority groups falling by an even greater extent. At the same time, homeowner vacancy rates have increased markedly over the past few years (Figure 1), and rental vacancy rates also have drifted upwards. This naturally begs the question: Where have these households gone?

One possibility is that households who have lost their homes have moved in with other households, or that households that might have formed during normal economic times have decided to delay their entry into the housing market. The study that led to this brief provides a comprehensive analysis of the role of the economic cycle, labor market, and housing conditions on household formation.

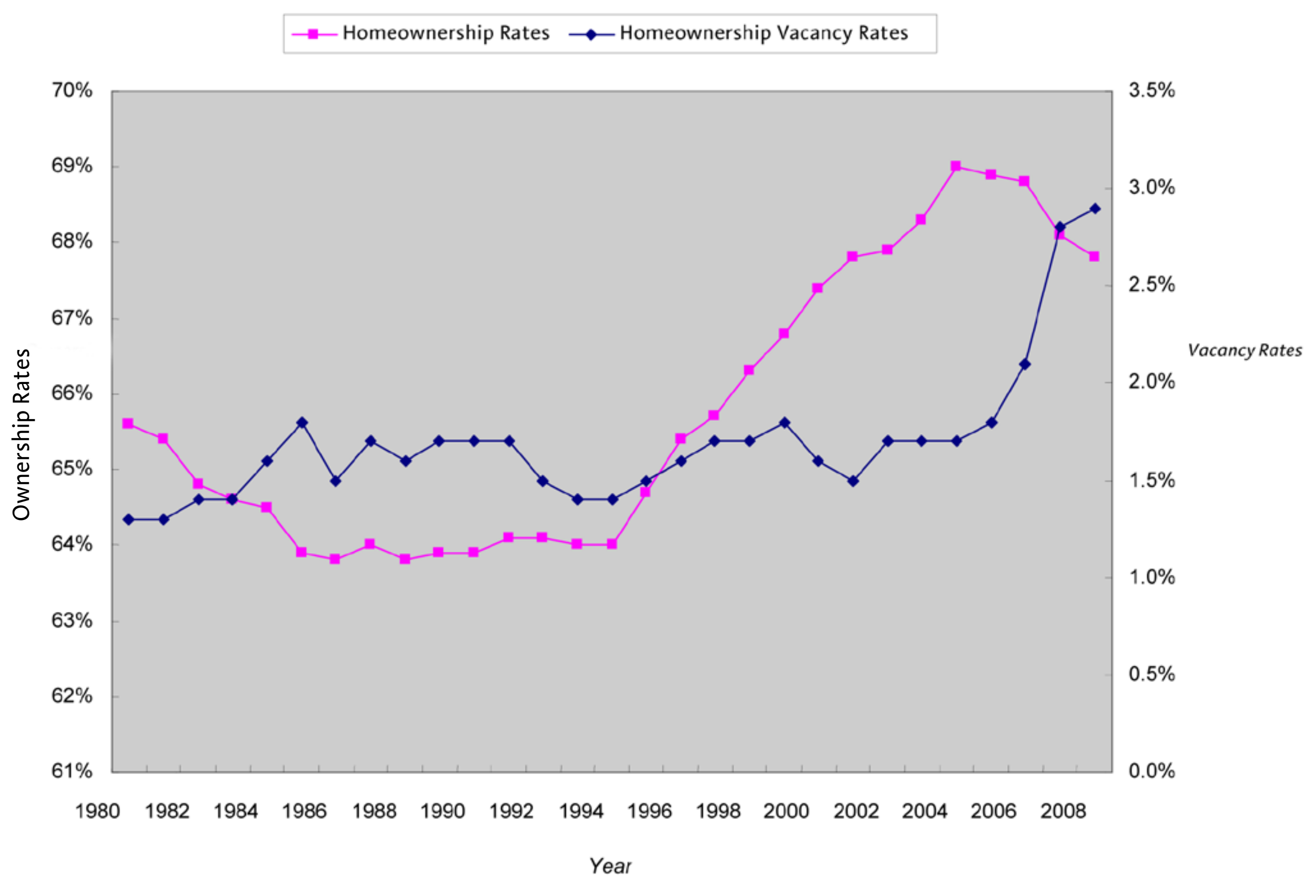
New households can be formed either when children move out of their parents' home, when couples separate, or when unrelated individuals choose to live singly after previously sharing a residence (Figure 2). The number of households can decline if two households combine, either through marriage, or by sharing a residence to reduce housing costs. In the current environment, household formation rates may well be depressed because fewer young households are heading out on their own, and because established households are combining to lower costs or due to the loss of homes through foreclosure.

Understanding how independent households form is critical in understanding housing outcomes. Much of housing policy has focused on homeownership rates because of the belief that owning one's home generates positive effects on the well being of residents, their children, and generates positive spillovers for the neighborhood (e.g., Green and White, 1997; Haurin, Parcel, and Haurin, 2002). Further, most of the literature on the determinants of owning one's home focuses on the transitions of independent renter households to become owners. Not commonly discussed is how the homeownership rate depends not only on transitions from renting to owning or owning to renting, but also on the number of people who form independent households (Haurin and Rosenthal, 2008). Thus homeownership rates can increase simply by the depression of renter households from the market (Myers and Yu, 2009).

In order to better understand the factors that lead households to establish their independence and to shed light on he role of the present economic environment, the study followed this three-step approach:

- Development of a Behavioral Model: The first step was to determine the economic and demographic factors that influence young people to form new renter or new owner households. The broad literature on household formation is summarized well in Billari and Liefbroer (2007). I used the Panel Study of Income Dynamics (PSID), which followed a large number of households over a long period, from1968–2007. Using these data, I determined which factors have influenced young people to form new rental and new owner households over time.
    - Not surprisingly, the decision to form a household is influenced by economic conditions. During recessions, young households delay entry into the housing market, and remain with their parents. Other households choose to share housing costs by combining households, leading to an increase in overcrowded dwellings.
    - I also found that declines in employment and increases in the unemployment rate during periods of recession reduce household formation rates. Specifically, a national recession suppresses the formation of new renter households, while higher unemployment rates suppress the formation of both new renter and owner households.
- Simulation: Using this behavioral model, I then simulated the likely impact of the current recession on household formation rates.
    - Simulations suggested that these declines are quantitatively important. For example, in a recession, the likelihood that a young adult will form an independent household falls by up to 4 percentage points depending on the age of the person as well as the severity of changes in the unemployment rate. By way of comparison, if an individual is unemployed, the likelihood of leaving the parental home is up to 10 percentage points lower.
- Detailed Analysis of the Current Environment: Finally, I utilized the American Community Survey (ACS) to compare 80 metropolitan areas in 2005 and 2008 with respect to mobility rates,

Figure 1. Homeownership and Homeownership Vacancy Rates, 1980-2008



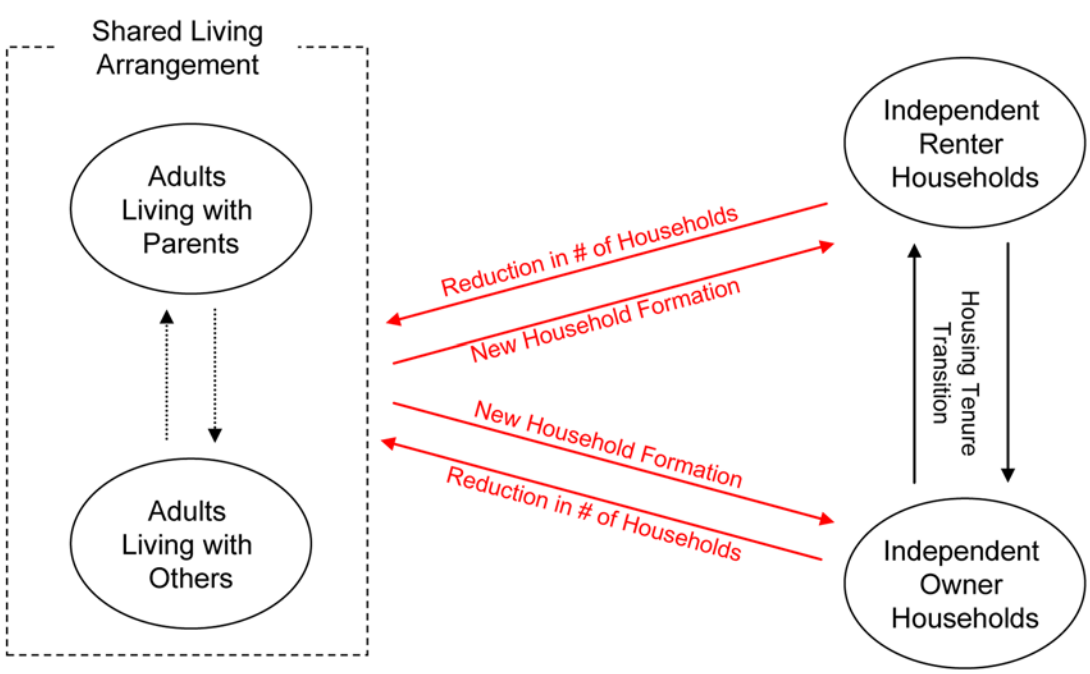
* Source: Current Population Survey/Housing Vacancies and Homeownership

overcrowding rates, homeownership rates, and household formation rates. With this much larger data set, I was able to highlight additional detail about the current environment that is not available in the PSID. In particular, I focused on the differences in patterns of household formation between immigrants and native-born households. I also closely examine the tenure choices of households that move. Given the analysis above, we would expect headship rates, the ratio of independent households, to have fallen and the rate of overcrowding to have risen during those three years. However, since homeownership rates are influenced by the relative speed at which the headship rates of potential owners and renters are depressed, the impact on homeownership rates would be indeterminate.

- Headship rates, a measure of the ratio of independent households to the population, have declined across metro areas and across both native-born and immigrant households. The impacts of the recession have been smaller in the smaller metros. These declines have been greater among native-born households, although the rates for immigrant households have fallen as well, albeit from a lower starting point.
- The recession has caused a dramatic increase in the rates of overcrowding, particularly in the "emerging gateway" metro areas, and particularly among native born households. This clearly indicates that many families are doubling up in response to the downturn.
- Overall, homeownership rates declined slightly for native born households in these metropolitan areas, and increased slightly for immigrants in the same areas. Both groups experienced slight declines in the large immigrant gateways, but immigrants actually increased their homeownership from 2005 to 2008 in the emerging gateways and in the smaller metropolitan areas. This suggests that as homeowners lost their homes, they were not being replaced by new owners. In fact, because new rental household formation has also been reduced by the recession, the decline in homeownership rates was less than it might have been.

The model estimated in the PSID, using data covering six recessions, predicts that the current recession likely caused rental household formation to fall by 2–4 percentage points and the formation of owner households to fall by about 1 percentage point. Confirming these predictions, data from the American Community Survey shows that household formation among native-born households in a sample of 80 of the largest metropolitan areas has fallen by up to 6 percentage points in young adult age cohorts, while exhibiting a slower rate of household formation across the age distribution.

Figure 2. Illustration of the Process of Household Formation and Housing Tenure Choice



Current economic forecasts suggest that unemployment is expected to decrease very slowly over the next two years. Additionally, many households have lost substantial portions of their wealth through this recession, which will make it more difficult for them to venture out on their own, or to come up with a down payment for a home purchase. While the recession is likely over, the model developed in this paper suggests that normal rates of household formation will not return until unemployment levels return to close to normal rates. Current economic forecasts suggest that unemployment rates should fall by a little more than 2 percentage points by the end of 2012. If this is correct, then the model suggests household formation should increase by about 2 percentage points from current levels by 2012, as people find jobs and recession induced anxieties abate. That would imply that by 2012, normal rates of household formation should re-appear, roughly 1–1.5 million new households per year, but it will take even longer before the United States completely recovers from the deficit in household formation caused by the severe recession. The clear implication is that there is no demographic silver bullet to solve the supply overhang in many housing markets around the country.

These results have important implications for both public policy and housing industry professionals. First, it appears the demand for multifamily housing was hit the hardest in recessions. This is evidenced by both the reduction in overall headship rates, and the only slight reduction in homeownership rates from 2005–2008. Second, in this recession, the homeownership rate likely declined due to people losing their homes, but part of the decline was mitigated by the decline in the formation of renter households caused by the recession.

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