SA422: Housing Economics and Finance  
2008/09  
Week 8: Reasons for Government Intervention

Objectives
• MAXIMISATION of WELFARE
• PRODUCTIVE and ALLOCATIVE EFFICIENCY  
  – ensure scarce resources used as effectively  
    as possible
• DISTRIBUTION/EQUITY  
  Vertical  
  Horizontal

PARETO OPTIMALITY
• ONE DEFINITION of MAXIMUM SOCIAL WELFARE
• EXISTS where RESOURCES ARE ALLOCATED in such a way that it is IMPOSSIBLE TO MAKE ONE PERSON BETTER OFF WITHOUT MAKING SOMEONE ELSE WORSE OFF
• ASSUMES CANNOT MAKE INTERPERSONAL COMPARISONS

• PARETO OPTIMALITY REQUIRES:  
  PRODUCTIVE EFFICIENCY  
  and  
  ALLOCATIVE EFFICIENCY

• A PARETO OPTIMAL SOLUTION EXISTS for EACH AND EVERY DISTRIBUTION of INCOME – ADDRESS EQUITY SEPARATELY
NECESSARY CONDITIONS to ACHIEVE PARETO OPTIMALITY

FOR EACH GOOD:

- PERFECT COMPETITION
- MAXIMISATION of UTILITY PROFIT
- FULL ASSIGNABILITY (no spillovers)
- FULL INFORMATION/ZERO TRANSACTIONS COSTS
- EQUILIBRIUM

L/R EQUILIBRIUM

\[
\begin{align*}
\text{MU}_x &= \text{MAX UTILITY} \\
\text{P}_x &= \text{Perfect Competition} \\
\text{MR}_x &= \text{PRICE TAKING} \\
\text{MC}_x &= \text{MAX PROFIT} \\
\text{min AC}_x &= \text{free entry} \\
\text{D}_x = S_x &= \text{EQUILIBRIUM}
\end{align*}
\]

SO FOR HOUSING

Require

A perfect market for housing would ensure

\[
\text{SMU} = \text{MU} = \text{P} = \text{MR} = \text{MC} = \text{min AC} = \text{SMC} = \text{min SAC}
\]
Why Housing Markets likely to be problematic

Special Attributes
- Heterogeneity/consumption good/asset
- Necessity/luxury good
- Indivisibility
- Longevity
- Spatial specificity
- Irregularity of decision
- Proportion of Income
- Importance in Government Policy
- Relation to macro-economy

What Type of Good is Housing?
- Private good:
  - Rival and excludable
  - Attributes provide very different utilities
  - Value of choice
- Social good:
  - Element of social wage?
  - Element of welfare state?
  - A merit good or just another good where there are market failures?

Housing on a spectrum from private to public

Different government choices about extent and nature of intervention

USA/Japan...UK...Scandinavia...Communist states
MAJOR SOURCES OF MARKET FAILURE

• PUBLIC GOODS:
  NON-RIVAL
  NON-EXCLUDABLE/REJECTABLE

• SO $MC_{\text{EXTRA,USER}} = 0$
  so should not charge

• CAN'T EXCLUDE
  so cannot charge

EXTERNALITIES

• Spillover effects of Individual DECISIONS

• Social $MU \neq$ Private MU

• Social $MC \neq$ Private MU

• BOTH POSITIVE and NEGATIVE
Evidence on Extent of Externalities

- Direct - overspill fire/spread of disease irrelevant in advanced economies? role of regulation → implications for affordability
- Externality/information/risk - overspill on occupiers health, education, employment possibilities, safety

Health

- Sources of concern:
  - Overcrowding
  - Cold, damp
  - Air quality
  - Mental health
- Issues:
  - Self reporting v. matched groups
  - Temporary accommodation/homelessness
  - Housing as cause v. poverty
  - Housing as means of delivery
Education/Access to Employment/Safety

- Impacts of schools on health very limited
- Instability – temporary accommodation
- Administrative costs
- Association with stress
- Positive impacts of housing investment/design

Interactive/Intergenerational Externalities

- Prisoners' dilemma and the generation of slums
  - Rationale for government intervention at any level of income?
  - Interaction with information/relative power
  - Evidence on regular v. irregular repair and maintenance
- Private v. social discount rates → under-investment
  - Capital market imperfections
  - Risk aversion

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NOTE: A and B are options, 1 is the loser’s expected behaviour. 
12 > 1.2 = 1 so decide NOT 1 — 1th optimal result

Figure 2: Interactive Externalities
MONOPOLY/IMPERFECT COMPETITION

- \( P > MC \)

- PRICE DISCRIMINATION
  PRICES differ between consumers producers

- INFORMATION
  - TRANSACTIONS COSTS
  - PUBLIC GOOD
  - ASYMMETRIC INFORMATION - POWER
  - MORAL HAZARD

- TIMING/WHO MAKES DECISION?
• RISK and ATTITUDES TO RISK
• RISK AVERSION
  – Individual
  – Markets: Finance
• INSURANCE
  BUT
• LARGE SPECIFIC PROJECTS

INTERDEPENDENCE of UTILITIES
• PATERNALISM?
• MERIT GOODS
  Who Pays?

Housing as a Merit Good?
• Distinguish merit good arguments from
  – Externalities
  – Distribution of income
• Social utility > private utility
  – Interdependence of utilities v. paternalism
  v. ‘no such thing as society’
• Housing as a means of achieving social objectives of distribution
EQUITY

• Equal opportunities for similar households
• Redistribution of Resources to poorer households
• Minimum standards for all

Why Redistribution via Housing rather than Income?

• Income subsidies increase individual welfare most BUT
  – price effects
  – social benefits of consumption
  – disincentive to work
  – political feasibility