

## IN THIS ISSUE

- Why is Manhattan Housing So Expensive?
- The Trouble with Stock Options
- Long-Term Care Insurance and Nursing Home Use
- Divorce Laws and Family Violence

## Why is Manhattan Housing So Expensive?

In recent years, Manhattan condominiums have been selling for about \$600 a square foot, more than double the cost of “building up,” that is, adding additional floors to new Manhattan apartment buildings. In **Why is Manhattan So Expensive? Regulation and the Rise in House Prices** (NBER Working Paper No. 10124), coauthors **Edward Glaeser**, **Joseph Gyourko**, and **Raven Saks** conclude that the piecemeal regulation of new construction has reallocated property rights from landowners to existing residents, public commissions, and ad hoc collections of vocal, well-funded, opponents. The successful use of the regulatory process to block new construction has thus imposed a regulatory tax on homeowners.

When landowners were generally free to develop their property, increases in housing prices stimulated the construction of new units. From 1955-69, relatively modest increases in the price of housing were associated with increases in the supply of building permits in the following year. This association continued to hold, although less strongly, in the 1970s. By the 1980s and 1990s, though, changes in price were not correlated with changes in permits, despite rising per capita income.

Because prices of existing homes rise when new construction

is constrained, existing residents have a strong incentive to manipulate political and regulatory processes to limit new construction. In Manhattan, the authors estimate these activities increase apartment prices by an amount equal to a regulatory tax of about \$7,382 per apartment per year, or about 50 percent of housing costs for these condo owners. For 23 percent of their sample, the additional burden

current gap between prices and production costs of condominiums in Manhattan... it is hard to escape the conclusion that regulatory constraints on building in Manhattan are far too restrictive.”

Because housing in other boroughs is far more reasonable than in Manhattan, the authors calculate that New York City’s overall regulatory tax was 12 percent of a house’s value in 1999. The San Francisco, San Jose,

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exceeds \$10,000 a year. In their view, the current “poorly defined, widely diffused property rights help us to understand why sensible mechanisms have not come about where developers efficiently compensate existing homeowners for any losses due to new construction.”

The next question is whether the regulatory tax reflects the social costs, congestion, wage effects, increased demand for city services, and the destruction of views and other amenities, generally thought to be imposed by new construction. After discussing the probable costs imposed by each of these factors, the authors conclude that “there is no negative externality (or combination of externalities) remotely large enough to justify the

Oakland, and Los Angeles markets, all in California, which is “well-known as the epicenter of the restrictions on new construction,” had regulatory tax ratios ranging from 32 percent to 50 percent of a house’s value. Washington DC, Newport News, VA, and Boston, MA, had regulatory taxes of about 20 percent. These markets were the exception. Over half of the housing markets examined by the authors imposed minimal regulatory taxes on homes. Taxes on homeowners in Chicago were 6 percent. In Cincinnati, Birmingham, Minneapolis, Tampa, Houston, Philadelphia, and Providence, homeowners paid no regulatory tax at all.

— Linda Gorman

## The Trouble with Stock Options

Stock options have become contentious. The root of the problem lies in widely held misperceptions concerning the cost of granting such options, according to **Brian Hall** and **Kevin Murphy** writing in **The Trouble with Stock Options** (NBER Working Paper No. 9784).

Stock options are compensation that give employees the right to buy shares at a pre-specified “exercise” price, normally the market price on the date of grant. The purchasing right is extended for a specified period, usually ten years. Between 1992 and 2002, the value of the options granted by firms in the S&P 500 rose from an average of \$22 million per company to \$141 million per company (with a high point of \$238 million reached in 2000). Over this period, CEO compensation skyrocketed, largely fueled by stock options. Yet the CEO share of the total amount of stock options granted actually fell from a high point of about 7 percent in the mid-1990s to less than 5 percent in 2000-2. Indeed, by 2002 more than 90 percent of stock options were being granted to managers and employees.

Hall and Murphy argue that, in many cases, stock options are an inefficient means of attracting, retaining, and motivating a company’s executives and employees since the company cost of stock options is often higher than the value that risk-averse and undiversified workers place on their options. In regard to the first of these aims — attraction — Hall and Murphy note that companies paying options in lieu of cash effectively are borrowing from employees, receiving their services today in return for payouts in the future. But risk-averse undiversified employees are not likely to be efficient sources of capital, especially compared to banks, private equity funds, venture capitalists, and other investors. By the same token, paying options in lieu of cash compensa-

tion affects the type of employees the company will attract. Options may well draw highly motivated and entrepreneurial types, but this can benefit a company’s stock value only if those employees— that is, top executives and other key figures — are in positions to boost the stock. The vast majority of lower-level employees being offered options can have only a minor affect on the stock price.

Options clearly promote retention of employees, but Hall and Murphy suspect that other means of promoting employee loyalty may

retain, and motivate employees, but from the standpoint of economic cost, options may well be inefficient.

Hall and Murphy’s analysis has important implications for the current debate about how options are expensed, a debate that has become more heated following the accounting scandals. A year ago the Financial Accounting Standards Board (FASB) announced that it would consider mandating an accounting expense for options, with hopes that this would be adopted early in 2004. Federal Reserve Chairman Alan

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well be more efficient. Pensions, graduated pay raises, and bonuses — especially if they are not linked to stock value, as options are — are likely to promote employee retention just as well if not better, and at a more attractive cost to the company. In addition, as numerous recent corporate scandals have shown, compensating top executives via stock options may inspire the temptation to inflate or otherwise artificially manipulate the value of stock.

Hall and Murphy maintain that companies nevertheless continue to see stock options as inexpensive to grant because there is no accounting cost and no cash outlay. Furthermore, when the option is exercised, companies often issue new shares to the executives and receive a tax deduction for the spread between the stock price and the exercise price. These practices make the “perceived cost” of an option much lower than the actual economic cost. But such a perception, Hall and Murphy maintain, results in too many options for too many people. From the perceived cost standpoint, options may seem an almost cost-free way to attract,

Greenspan, investors like Warren Buffet, and numerous economists endorse recording options as an expense. But organizations such as the Business Roundtable, the National Association of Manufacturers, the U.S. Chamber of Commerce, and high-tech associations oppose “expensing” options. The Bush Administration sides with these opponents, while Congress is divided on the issue.

Hall and Murphy believe that the economic case for “expensing” options is strong. The overall effect of bringing the perceived costs of options more in line with their economic costs will be fewer options being granted to fewer people — but those people will be the executives and key technical personnel who can realistically be expected to have a positive impact on a company’s stock prices. The researchers also point out that current accounting rules favor stock options at the expense of other types of stock-based compensation plans, including restricted stock, options where the exercise price is set below current market value, options where the exercise price is indexed to

industry or market performance, and performance-based options that vest only if key performance thresholds are reached. Current rules are likewise biased against cash incentive plans that can be tied in creative ways to increases in shareholder wealth.

Hall and Murphy conclude that managers and boards can be educated about the true economic costs of stock options and other forms of compensation, and that the asymmetries between the accounting and tax treatment of stock options and other forms of

compensation must be eliminated. Proposals to impose an accounting charge for option grants would close the gap between perceived and economic costs.

— Matt Nesvisky

## Long-Term Care Insurance and Nursing Home Use

People who have private long-term care insurance are no more likely to enter a nursing home than people without this insurance, according to NBER researchers **Amy Finkelstein** and **Kathleen McGarry**. On the surface, this finding is surprising. One might think that individuals who know that they have a high risk of using a nursing home would be more eager to buy insurance against this risk. Similarly, once they have insurance to cover the costs of a nursing home, they might be more likely to use it than if they had to pay these costs out of their own pocket. At least this is what economists would expect, based on what they have found in related markets, such as health insurance for individuals under age 65, or health insurance to supplement the public Medicare coverage for individuals over age 65. In **Private Information and its Effect on Market Equilibrium: New Evidence from the Long-Term Care Insurance Market** (NBER Working Paper No. 9957), the authors explore why individuals with long-term care insurance have similar nursing home use to the general population.

The long-term care market is particularly interesting because, although many elderly face the possibility of substantial out-of-pocket expenditures, most choose not to purchase private insurance. In the year 2000, expenditures for long-term care totaled approximately \$100 billion (or 7.5 percent of all health expenditures for all ages).

Expenditures are projected to triple in real terms over the next 40 years as the baby boomers age and medical costs rise. Yet very little of this long-term care expenditure risk is insured; 40 percent of long-term care costs were paid for out of pocket in 2000, compared to only 17 percent of overall health expenditures. The authors estimate that only about 10 percent of the elderly have private long-term care insurance.

Using public-use micro data from the Asset and Health Dynamics (AHEAD) cohort of the Health and Retirement Study, Finkelstein and McGarry find that there are two types of elderly individuals who pur-

entering a nursing home in the next five years. They compare that individual's assessment to what an industry actuarial model would predict for the same individual based on age, gender, limitations to activities of daily living, and cognitive function. They find that individuals who think that they are more likely to go into a nursing home than the insurance companies expect are more likely to buy long-term care insurance; these individuals also are more likely to go into a nursing home than individuals who appear the same to insurance companies but do not purchase insurance. This suggests that the problem of what

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“Although they are more likely to buy insurance, ... cautious individuals are actually *less* likely to use a nursing home.”

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chase private long-term care insurance: individuals who assess themselves as more likely to use a nursing home than the insurance industry would think they are, and individuals who are more cautious than the general population. The first group does in fact have above-average nursing home use, while the second group has below average nursing home use. Because both high risk and cautious (but low risk) individuals purchase long-term care insurance, the insured population on average has the same risk profile as the population as a whole.

The authors draw on an innovative question in the AHEAD survey that asks the elderly respondents to report their self-assessed chance of

economists call “asymmetric information” — that individuals have private information that the insurance company does not have — exists in the private long-term care insurance market.

However, Finkelstein and McGarry find that a second group of individuals is also more likely to purchase insurance than the general population. These individuals appear to be more cautious, as measured by their use of preventive medical services, such as flu shots and cholesterol exams; although they are more likely to buy insurance, these cautious individuals are actually *less* likely to use a nursing home. Health economists refer to such individuals as the “worried well.”

## Divorce Laws and Family Violence

In 1969, then Governor Ronald Reagan signed a bill creating unilateral divorce in California. Following California's lead, many states subsequently increased access to divorce, making it possible for a married person to seek a divorce without the consent of his or her spouse. Earlier divorce laws typically required either the consent of both parties or a demonstration of marital fault.

In **Bargaining in the Shadow of the Law: Divorce Laws and Family Distress** (NBER Working Paper No. 10175), co-authors **Betsey Stevenson** and **Justin Wolfers** evaluate three measures of family well being — suicide rates, domestic violence, and murder — to determine the effects of reforms nationwide that created unilateral divorce laws.

The authors find very real effects on the well being of families. For example, there was a large decline in the number of women committing suicide following the introduction of unilateral divorce,

but no similar decline for men. States that passed unilateral divorce laws saw total female suicide decline by around 20 percent in the long run. The authors also find a large decline in domestic violence for both men and women following adoption of unilateral divorce.

for some women.

The option of unilateral divorce action changes marital dynamics, by increasing the bargaining power of the dissatisfied spouse. Prior to unilateral divorce, a spouse always had an option to leave the marriage, but could not

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“States that passed unilateral divorce laws saw total female suicide decline by around 20 percent in the long run.”

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Finally, the evidence suggests that unilateral divorce led to a decline in females murdered by their partners, while the data reveal no discernible effects for homicide against men.

In a sense, domestic violence may decrease under unilateral divorce laws because this framework makes credible the threat to leave the marriage if abused. If the abuser wishes to continue the marriage, then this threat may be enough to prevent abusive behavior. Likewise, unilateral divorce may offer a credible alternative to suicide

remarry without the other spouse agreeing to a divorce, or without the dissatisfied spouse going through a difficult legal process to demonstrate marital fault. Under unilateral divorce, the dissatisfied spouse gains additional bargaining power, since he or she controls both the leaving and remarriage decisions.

The data presented by the authors offers empirical endorsement of the idea that family law provides a potent tool for affecting well being within families.

— Les Picker

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