Professor Mark Stephens on behalf of the Joseph Rowntree Foundation – Written evidence (EHM0115)

SUBMISSION TO THE SELECT COMMITTEE ON ECONOMIC AFFAIRS

INQUIRY INTO THE ECONOMICS OF THE UK HOUSING MARKET

The Joseph Rowntree Foundation's Housing Market Taskforce (Stephens, 2011) was established 2009 and reported in 2011. It was made up of an interdisciplinary group of experts who were charged with identifying long-term solutions to the problem of house price volatility in the UK. Its recommendations were aimed at creating a more socially sustainable housing market in which vulnerable households are better protected from the effects of volatility. Although its report was drafted during the first year of the Coalition Government five years ago, it provides a framework for providing responses to the questions being addressed by the House of Lords Select Committee on Economic Affairs Inquiry into the Economics of the UK Housing Market.

The main points in this submission are:

- The UK faces a long-term failure of housing supply to keep up with demand. This has contributed to the UK's volatile housing market.
- Government schemes are likely to benefit the people who take advantage of them, but are likely to contribute to the maintenance of generally high prices. They are becoming part of a system that keeps house prices artificially high.
- The effects of Stamp Duty concessions are likely to benefit owners of property as they are "capitalised" into higher prices.
- Stamp Duty thresholds should be uprated automatically to avoid fiscal drag.
- There is a case for reviewing the impact of the Mortgage Market Review.
- Buy-to-let mortgages should be brought within the remit of both the Financial Policy Committee (macro-prudential regulation) and the Financial Conduct Authority (micro-prudential regulation).
- The Committee should explore the reasons why insurance products that facilitate higher LTV loans are no longer available from the market.
- The role of the planning system in inhibiting new housing supply may have been exaggerated. It should be explored alongside a wider review of the supply of land, the role of development gain and the provision of infrastructure. The role of land auctions and the taxation of vacant land should be considered.
- The reduction of tax relief to private landlords adds to the tax advantages enjoyed by owner-occupiers. The additional costs are most likely to be passed on to tenants in high demand markets, where affordability is already most stretched.

- Regulation that is sensitive to the market can play a valuable role in creating a rental culture, but that it cannot be used as a long-term solution for chronic housing shortages.
- Social rented housing is the most suitable option for households that seek long-term security, but who cannot safely access owner-occupation.
- Its supply is threatened by the extension of Right to Buy and enforced rent reductions. However, the Starter Home scheme poses a direct threat to new social rental provision through the diversion of planning obligations away from it.

The housing problem

The Taskforce identified volatility, as manifested by rapid fluctuations in house prices, as being a persistent feature of the UK housing market over the past 40 years. Such instability distorts housing choices, increases risk, drives mortgage arrears and repossession rates, as well as affecting housebuilding and intergenerational equity. Although home-owners are most directly exposed to volatility, private tenants are not immune. Indeed rates of credit loss on buy-to-let mortgages are now higher than among owner occupiers (FPC, 2015).

The Taskforce noted that governments have tended to make short-term responses to periodic crises in the housing market, and the response to the post 2008 crisis has to date been no different. An active monetary policy has been used to reduce and maintain interest rates at historically low levels of 0.5 per cent. A programme of quantitative easing involved the Bank of England purchasing Government bonds worth £375 billion between 2009 and 2012 (Bank of England, n.d.).

Such measures have protected the economy, but also arguably prevented full correction in house prices, whilst encouraging further investment in property through routes such as buy-to-let. By April 2014, average nominal UK house prices were 6.5 per cent higher than the pre-crisis peak in 2007/08. This masks regional variations, so prices in London, South East and East regions were higher than before the crisis, but still lower elsewhere in Great Britain. Indeed London, with prices more than 30 per cent above pre-crisis levels and approaching £500,000, increasingly appeared distinct from the rest of the country. Only in Northern Ireland – living with the repercussions of the Republic of Ireland's boom and bust – and where prices in April 2014 were still almost 50 per cent below the 2007 figure has a large correction taken place (ONS, 2014). It is clear that in some parts of the country at least another period of sustained house price rises is underway. The Government's latest prediction suggests a 5 per cent annual increase over the next five years (HM Treasury 2015b). This implies a real increase in prices of almost one-fifth over five years (based on the Government's CPI inflation forecasts).

The other side of macroeconomic policy has been marked by fiscal consolidation. The Government has now adopted a target of moving to a surplus by the end of this Parliament. The programme of fiscal consolidation has included the reduction in per unit subsidy for rental accommodation (the "affordable rent" model), as well as reductions in means-tested support to low income private and social tenants through restrictions in Housing Benefit.

The Taskforce stressed the importance of looking at the housing market as a whole. It argued that private renting offers insufficient security to provide stability for households especially those with children. Moreover, it argued that social rented housing is likely to provide the most suitable option for households that seek long-term security but cannot access full or shared ownership safely.

The Taskforce identified the long-term imbalance between housing demand and supply as being the principal underlying cause of volatility. It concluded that because annual increases of supply can make only a small impact on the overall balance between demand and supply, it would take some decades to rectify it fully. Consequently, other measures, including capital adequacy requirements for lenders, credit controls, property taxation, planning, infrastructure and the treatment of development gains should be considered. This assessment remains valid. The Future Homes Commission (2012) estimated that 300,000 new homes are needed each year in the UK. Holmans (2013) suggested that between 240,000 and 245,000 are needed. The UK Government suggests that the figure lies between 200,000 and 300,000 units (House of Commons, 2015).

Private Ownership

<u>Government schemes</u>

The Government now operates four main schemes to support purchasers in the housing market.

The Help to Buy *equity loan* scheme is targeted on new properties – albeit at values that extend beyond *twice* the national average. Some £4.3 billion loans were advanced by June 2015 (DCLG, 2015), supporting the purchase of 102,500 properties. By number and value, around 45 per cent of equity loans helped first time buyers. The scheme has been extended to 2021 and in the Spending Review and Autumn Statement, the Government's maximum stake of 20 per cent was been doubled for purchasers in London. The *mortgage guarantee* scheme, whereby the Government guarantees the top 20 per cent of a 95 per cent mortgage was introduced (also under the "Help to Buy" banner) for first time purchasers of both new and existing properties. Some 46,877 properties were purchased across the UK under this scheme between October 2013 and March 2015. More than 40 per cent of properties were priced under £125,000 and more than 50 per cent under £150,000 (HM Treasury, 2015a).The *starter homes* initiative, will provide some £2.3 billion of subsidy to builders to provide 20 per cent discounts to first time buyers of properties valued up to

£250,000 (or £450,000 in London). It is expected to yield 200,000 properties. Meanwhile the *income limits* (of £80,000 outside London and £90,000 in the capital) on Help to Buy *shared ownership* are being abolished. The removal of these already high income limits suggests that shard ownership has moved a long way from its original objective of providing either an intermediate tenure, or a stepping stone to full ownership, for aspirational households on modest incomes.

These schemes largely deal with the symptoms of the problems of the housing market, rather than the underlying cause. It might well be questioned why, when the owner-occupation market operated without such interventions throughout entire C20th, that they should now become a normalised part of it. It is estimated that *one-third* of first time buyers received state assistance in 2014 (and one-third received assistance from their parents) (Wilcox, *et al*, 2015).

The fall in home-ownership among younger age groups set in well before the financial crisis limited the supply of mortgages. It therefore began when finance was plentiful, and 100% mortgages were available. It began because potential first time buyers could not afford to service such large loans. In other words the affordability constraint kicked in before the loan-to-value constraint.

The measures are likely to be of benefit to the people who take them within the context of a housing market that is unable to produce sufficient numbers of houses at prices people can afford. However, they seem likely to contribute to the maintenance of generally high house prices, and therefore have become part of system that keeps house prices artificially high. Moreover, they do little to encourage developers and builders to alter their business models in ways that enable them to produce more homes at affordable market prices

Stamp Duty Land Tax (SDLT)

The system of SDLT has become significantly more complex over the past 20 years. Economists generally believe that transaction taxes are inefficient and in the case of the housing market inhibit mobility. SDLT has also become a significant (if volatile) source of revenue, and for that reason alone, it seems unlikely that the Government would wish to abolish it, and incur the displeasure of residents generally if the revenue was instead raised by a recurrent tax on property.

The “slab” structure that has now been abolished throughout the UK, was widely criticised for its lack of fairness and the way in which it distorted the market, particularly as graduated rates were introduced. (Purchase prices would cluster just below thresholds.) The slice structure introduced in 2015 is therefore preferable to that which went before it. However, when analysing the effects of SDLT it is important to recognise that there is likely to be a significant capitalisation effect. In other words, there is a need to distinguish between the formal and actual incidence of the tax. Whilst the purchaser formally pays the tax, it is likely that a good deal (if not all) of its cost is borne by the seller. The tax formally reduces the purchasing power of the buyer, and therefore actually reduces the price that the seller can command. Hence the question as to whether the new structure favours first time buyers may be misplaced.

It would seem sensible to monitor the operation of the new structures of SDLT. However the schemes operated by the UK and Scottish governments lack a mechanism for automatically uprating thresholds to prevent them becoming out of date. In the past this has led to significant "real fiscal drag" as transactions that remain in lower parts of the market are taxed more heavily as they pass into higher nominal bands. The Taskforce observed that the adjustment of thresholds upwards generally occurred when prices were rising, and therefore had a pro-cyclical effect. A system of automatic re-rating of thresholds would therefore be preferable to *ad hoc* adjustments.

Mortgage regulation

The origin of the Global Financial Crisis lay in the growth of the growth of the sub-prime mortgage market in the United States, the risks of which were globalised by the securitisation of mortgages which were sold to banks around the world. Within the UK, it was widely acknowledged that our own sub-prime market, and other examples of excessive lending, contributed to difficulties experienced by some financial institutions. Such lending left borrowers exposed to economic downturns and necessitated significant interventions in the housing market to protect home-owners.

The Mortgage Market Review (MMR) (FSA, 2009) was established as a response to this experience. The Taskforce took the view that the MMR's recommendation that mortgage lending should be based on a more realistic assessment of affordability (in place of "rules of thumb") was welcomed. The approach taken does not prohibit interest only mortgages, but does insist that affordability calculations be based on the repayments required for a capital and repayment mortgage. The Taskforce recommended that the new system be monitored to assess whether it was leading to overly restrictive lending. Sufficient time has elapsed to allow the new system to have bedded down, and such a review would now be helpful.

The Committee might wish to investigate a suitable response to the situation whereby first time buyers' have the capacity to service higher LTV loans than lenders will provide. The existence of the Help to Buy Mortgage Guarantee scheme suggests that this is indeed the case. The Committee may wish to investigate as to why guarantee products are no longer provided by the market. A system of "mortgage indemnity guarantees" (MIGs) commonly operated on high value mortgages from at least the 1950s up until the mid-1990s, but has since disappeared. Under MIGs, the borrower paid a one-off premium that was used to insure the lender against losses on high LTV loans. It is true that the insurance companies incurred heavy losses on these products as a consequence of the early 1990s housing market downturn. This might suggest that the products were mis-priced, poorly structured, or that greater attention to affordability was required. There may now be regulatory or other barriers to the provision of such products, in which case these should be investigated. It seems surprising that a financial services industry that is vastly more sophisticated than in the 1950s appears unable to provide such a relatively simple product, and instead relies on the state to do so.

One clear anomaly in the system should be addressed. The exclusion of most buy-to-let mortgages from both macro and micro-prudential regulation is an anomaly that has existed since owner-occupiers' mortgages were first regulated in 2004. In terms of macro-prudential regulation the Financial Policy Committee has requested that the powers of Direction that it enjoys over owner-occupiers' mortgages be extended to cover the buy-to-let sector (FPC, 2015). However, the exclusion of buy-to-let mortgages from the affordability and other provisions of regulation by the Financial Conduct Authority may provide buy-to-let purchasers with a regulatory advantage in terms of access to mortgage credit over would-be owner-occupiers. The Chancellor suggested that this was a reason behind his decision to reduce tax reliefs to buy-to-let landlords. It would seem more sensible to tackle the anomaly where it arises, rather than introducing a new one elsewhere in the system.

Planning

The planning system is frequently blamed for inhibiting housing development. The Taskforce took the view that the supply-side needs to be examined in the round.

Whilst there may be a case for reviewing some aspects of the planning system, it should be noted that it is already weighted in terms of procedure in favour of applicants, which enjoy a right of appeal that is not open to third parties. Moreover, volume builders and building supply companies are much better resourced to employ legal representation and technical advice in the event of public inquiries or hearings than are community groups or, increasingly, local authorities. Aubrey (2015b) has estimated that there exist 800,000 building plots with planning permission that have not been built on, and, at the current rate of granting permission, there is will be 2 million such plots by 2020.

The inquiry might be open to the possibility that rather too much emphasis is placed on the planning system in the supply of housing. Its role should be considered alongside the supply of land, the role of development gain, the economics of the housebuilding industry, and the provision of infrastructure. There exists a central tension in the planning system between the ownership of development rights by the state, and the benefits that arise from the uplift in land values that arise from the state granting permission.

The Taskforce suggested that land auctions and the taxation of vacant land might be required to encourage the reluctance of landowners to release land and developers to develop it. A recent report suggested that the German planning system is more effective in limiting the landowner from capturing the value of the development gain, which can as a consequence be directed towards paying for infrastructure and limiting the impact of permission being granted on house prices (Aubrey, 2015a).

Privately Rented Accommodation

Tax relief

Historically, private rented and owner occupied housing were taxed in the same way. Both landlords and owner occupiers could deduct mortgage interest payments from their income, and both paid tax on rental or imputed rental income. The latter was abolished for owner occupiers in 1963 as a populist measure. For many years, academics and others argued for equal treatment between tenures. Over a protracted period, mortgage interest relief for owner occupiers was phased out; it was eventually abolished in 2000. Since then the tax relief on landlords' mortgage interest has continued to be balanced by taxation of rental income; and the owner occupier exemption from tax on imputed rental income balanced by the lack of interest relief. Nonetheless, owner occupiers still enjoy the significant tax advantage over private landlords, namely being exempted from paying Capital Gains Tax.

The Chancellor's proposals to reduce the tax relief enjoyed by landlords therefore have no foundation in the principles of tax. Moreover, his claim that, *"The current tax system supports landlords over and above ordinary homeowners"* (HM Treasury 2015a, para. 1.190) is simply incorrect. As argued above, if landlords are thought to enjoy unwarranted advantages in the mortgage market, then the appropriate solution is to remove the anomaly whereby their mortgages are not subject to regulation. It is bad policy to attempt to correct one anomaly by introducing another one elsewhere in the system.

Whether the measure will result in higher rents will depend on the state of the local market. Landlords are often happy to leave rents unchanged – or moderate increases - when they are satisfied with their tenants. It may be in stronger markets, landlords may seek to pass on additional costs. In weaker markets, landlords will be less able to pass on additional costs. Consequently, the policy is most likely to weaken affordability for tenants, precisely where affordability is already strained. At the margins the policy may cause some landlords to exit the market, particularly if the policy co-incides with rising interest rates.

Decline in owner-occupation and a rental culture

The long-term decline in owner-occupation may continue because of the cohort effect. It is likely to depend on whether the people in their 30s "catch up" with their counterparts in previous generation before it is too late to sustain a 20+ year mortgage. Just as the cohort effect of rising owner occupation among older owners had the effect of slowing the overall decline in the home ownership rate, so over time the cohort effect of lower ownership levels among younger age groups will tend to depress the ownership rate as they themselves grow older (see Table 1).

Table 1 Tenure change 2003/04-2013/14

2003/04	Owned outright	Buying with a mortgage	Social rented	Private rented	2013/14	Owned outright	Buying with a mortgage	Social rented	Private rented
16-24	2	22	29	47		2	7	23	67
25-34	3	56	18	23		2	36	17	44
35-44	7	64	18	11		7	53	17	23
45-54	22	56	15	7		20	50	17	13
55-64	49	31	16	5		48	27	16	9
65+	65	4	26	5		71	4	19	5
All	30	39	20	11		33	31	18	19

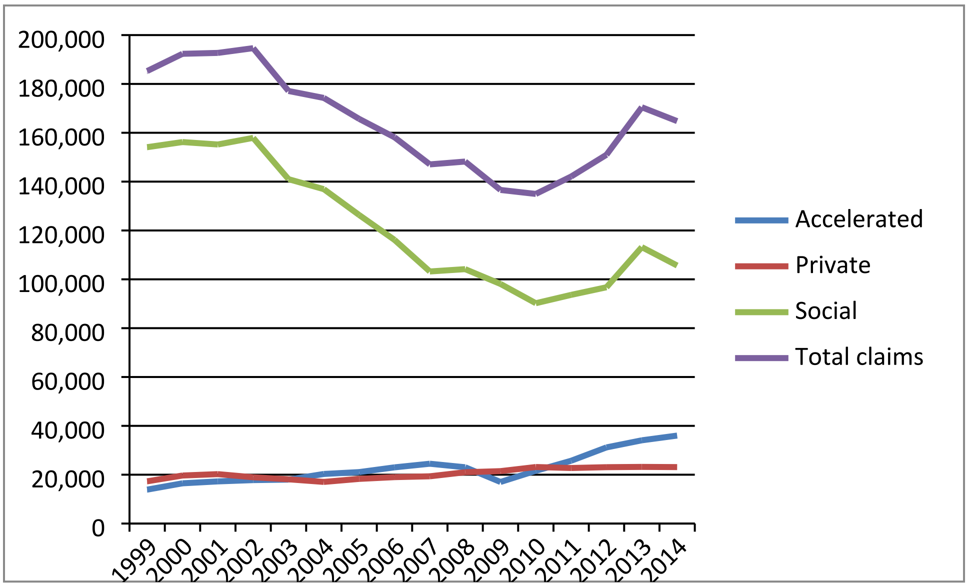
Source: DWP (2015), Table 2c

It is desirable that a long-term rental culture be created, given that many more people are now dependent on private renting than was the case in the 1970s-2000s. Such a culture depends on developing long-term relationships between renters and landlords.

The insecure nature of assured shorthold tenancies is a great source of insecurity. Figure 1 shows that there has been a modest rise in possession claims from private landlords since the late 1990s. However, the true picture is difficult to assess because there has been a marked rise in "accelerated" claims, which are used when tenancies are nearing their end. The statistics for these claims do not distinguish between social and private landlords.

Moreover, the *persistent possibility* that a tenant might lose their home is also important. Landlords tend to favour assured shorthold tenancies because they make it easier to remove tenants who are unreliable payers of rent or whose behaviour is not acceptable. Although non-payment of rent and antisocial behaviour are likely to be statutory grounds for eviction in a secure tenancy, a "no fault" eviction on the termination of a fixed tenancy is both certain and straightforward. A compromise might be to allow a six month initial tenancy to be followed by conventional security should both parties agree.

Figure 1. Landlord Possession Claims (England and Wales, 1999-2014)



Source: Ministry of Justice (2015), Table 5

Rent regulation

There is a widespread perception that rents have risen rapidly. Certainly in London nominal rents in June 2015 were nearly 18 per cent higher than in January 2011, but the figures for England outside London (6.6%), Wales (3.3%) and Scotland (7%) are more modest (ONS, 2015a), and indeed below the rate of consumer price index which grew by 9.2 per cent over the same period (ONS, 2015b, Table 22a). Nonetheless, an unusually liberal approach is taken to rent setting in the UK. The German system of allowing initial rents to be set by the market, but controlling subsequent increases ("second generation" rent controls) seems attractive. These limits are normally 20 per cent over a three year period, but in most States these have been reduced to 15 per cent. In especially pressurised markets, caps on new rents are being imposed, too.

This approach is echoed in that being adopted by the Scottish Government. After a lengthy period of consultation, a new bill was published in October 2015 to introduce

> *"… a new private residential tenancy for the private rented sector which will improve security of tenure for tenants and provide appropriate safeguards for landlords, lenders and investors."* (Scottish Government, 2015b, p.2)

In principle the legislation will end *"no fault"* evictions, but there remain grounds for possession, which include an intent to refurbish or sell the property. It also gives Ministers powers to impose caps on rent increases in *"rent pressure zones"* bringing with it the prospect of the selective use of so-called *"second generation"* rent controls.

Rent controls and regulation of course can bring risks. It is commonly accepted that the kind of rent control operated in the UK in the 20th century, including the “fair rent” model operated in the 1970s, contributed to the decline in the sector. Even if they remain in the sector, landlords may “game” systems that they regard as being too onerous. A paper commissioned from Professor Michael Ball by the Taskforce suggested that almost any kind of regulatory intervention has perverse consequences (Ball, 2010). For example, he suggested that security of tenure would lead to landlords declining to house households (notably families with children) that were likely to wish to remain in the property for a long time.

Whilst the German system does generally work well, there is evidence from other countries that excessive regulation, particularly when imposed in the face of market shortages, can lead to dysfunctional systems. The Swedish system, whereby rent increases are negotiated annually between the Tenants’ Union and representatives of the municipal and private landlords under a regime of strong security, is breaking down because of acute shortages. The system works to the advantage of the “insiders”, but those people who are “outside” the system often depend on legal or illegal sub-lets and controlled tenancies re-sold at market prices (Stephens, 2015).

The lesson is that regulation that is sensitive to the market can play a valuable role in creating a renting culture, but that it cannot be used as a long-term solution for chronic housing shortages.

Social housing

Social rented housing plays a vital role in the UK housing system. As the Taskforce noted it is “social rented housing is likely to provide the most suitable option for households that seek long-term security but cannot access full or shared ownership safely” (Stephens, 2011, p.11). In this respect the Government’s proposed amendments to the Housing Bill that would introduce fixed-term tenancies would undermine this function considerably over time.

<u>Right to Buy</u>

The *de facto* extension of right to buy, if rolled out to all housing association tenants, would open up the possibility of ownership to some 1.8 million housing association tenants. Analysis conducted for JRF by the University of Cambridge (Clarke et al, 2015) estimates that around one in five of those who gain the Right will be able to afford to buy and expects an average of 25,500 tenants to exercise this right annually over the first five years. The scale of anticipated subsidy involved is very high indeed: some £95,500 per dwelling in London and £63,000 in the rest of the country (Savills, 2015). The impact of the policy might be considered in terms of opportunity cost, as well as the notional change in social rented stock, i.e. what else could be done with the subsidies.

Rent restrictions

The policy of rent reductions of 1 per cent per year for four years from 2016/17 under the Welfare Reform and Work Bill (published in July 2015) applies to both local authority and housing associations, and is motivated by a wish to reduce the pressure on Housing Benefit. (HM Treasury (2015a) predicts savings of £1.445 billion in 2020/21.) The measure will reduce housing associations' ability to borrow to support the building of new social rented housing. At least one housing association (Genesis) announced its abandonment of new social rented housing, and others have considered doing the same (Slawson, 2015).

Starter Homes and S106

The subsidy of Starter Homes from the diversion of developers' S106 planning obligations away from social and other forms of "traditional" affordable housing will inevitably reduce the availability of such housing. Such obligations supported the production of 32,000 affordable homes in 2006-07 (65% of the total) and 16,193 (37% of the total) in 2013/14 (Brownhill, *et al*, 2015).

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