

## COMMENTARY: UK HOUSING MARKET: PROBLEMS AND POLICIES

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Housing is at the top of our political agenda. This is appropriate given that housing is a necessity as it is essential for the security and well-being of our families. Article 25 (1) of the United Nations Declaration of Human Rights recognises housing as part of citizens' right to a "standard of living adequate for the health and well-being of himself and his family."

There is mounting evidence that we are failing to deliver decent housing, especially for the younger generation. First, more and more houses are being bought for investment purposes which raises the cost of housing. Second, older generations appear to be 'under occupying' and even hoarding houses while younger generations are struggling to move into homes. Third, the number of new homes continues to fall below the number of new families. Fourth, the re-classification of housing associations may leave this essential source of housing for lower income families less able to access long-term stable funding.

This *Commentary* looks at the problems in the UK housing market and considers fundamental reforms to housing taxation and housing finance.

### Home ownership trends

Housing policy is complicated because houses perform several functions at once. First and foremost, houses provide shelter. An obvious measure of a well performing housing market is if there are enough houses for everyone. The Office for National Statistics (ONS) estimates that there were roughly 27.5 million dwellings (excluding long-term vacant houses) and 26.5 million households

in 2013. But there may be problems on the horizon. The ONS estimates that the number of new households is projected to increase by 250,000 per year over the next decade while the number of net new houses completed over the past decade averaged 175,000 per year.

The share of households who are owner occupiers has fallen from 69 per cent to 63 per cent over the past decade. This headline figure masks interesting and divergent trends. Ownership among people under 34 has fallen by around 20 per cent, while ownership by those over 75 has actually increased. The decline in the owner occupation rate matches the rise in households in the private rented sector and coincides with a steep rise in the number of households who own additional homes.

A new trend in home life is the rise in the number of households with shared families. For example, children staying at home with their partners at their parents' home. This trend was relatively steady until 2006 but has since started to rise by around 7 per cent per year. The sudden change in trend suggests this has more to do with affordability than preferences.

Overcrowding is almost exclusively found in rented homes rather than owner occupied. At the same time a remarkable phenomenon called 'under occupied' housing is on the rise. An 'under occupied' home is defined as having two or more spare bedrooms. According to the English Housing Survey, 61 per cent of those who own their house outright are said to 'under occupy', compared to 39 per cent of mortgage holders and only 15 per cent of private renters.

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This evidence suggests some degree of hoarding housing consistent with housing being a store of wealth. Owners are happy to ‘under occupy’, many households are buying second properties and the older generation are not releasing equity by leaving owned property towards the end of their life. The market is clearing through higher house prices which prevents those in the early years of adulthood, who have most housing cost risk, from becoming owners.<sup>1</sup> This suggests that the market is becoming less efficient in allocating housing on a basis of needs.

### Investment returns

Housing is also the most important asset we own. Households have more wealth invested in housing than any other asset including pensions. In 2014 the value of households’ and non-profit institutions’ dwellings was £4.43tn (ONS data). This is 58 per cent of the entire net wealth of the UK. Figure 1 shows ONS data for personal sector housing and net financial wealth as a share of disposable income. The rise of housing wealth reflects higher owner occupation and house prices. According to Savills, landlords with mortgages now have more housing market equity than owner occupiers with mortgages.<sup>2</sup>

It is not only British households that invest. In a world where secure assets with a positive yield are scarce, UK property is popular with overseas investors. A popular private sector buy-to-let index suggests that annual gross returns have been above 10 per cent since the start of 2014.<sup>3</sup> UK property has all the essential attributes of a secure asset, such as complete records of ownership and

courts that uphold property rights. According to *Property Week*, the annual amount of overseas investment has risen from around £6bn per year a decade ago to £32bn in 2014.

Indeed, UK housing has been a sound bet for decades. Over the past twenty years the price of an average house has risen by 7.3 per cent per year, higher than a 6.3 per cent total return (dividends reinvested) in the FTSE100 stock index. However, assuming a very modest rental yield net of depreciation and repairs of 2 per cent takes the return on housing significantly higher than other assets and much less volatility.

The difference is even greater when considering the after tax return. Home owners pay council tax and stamp duty when they move (1 per cent on the average home) which are small relative to overall housing costs. Wealth in housing is also sheltered for means testing, which becomes especially important when faced with uncertain late in life health costs, and increasingly sheltered from inheritance tax. By comparison, owners of financial assets pay income and capital gain taxes. Therefore, the after-tax and risk-adjusted rate of return on housing has been far in excess of other investment options.

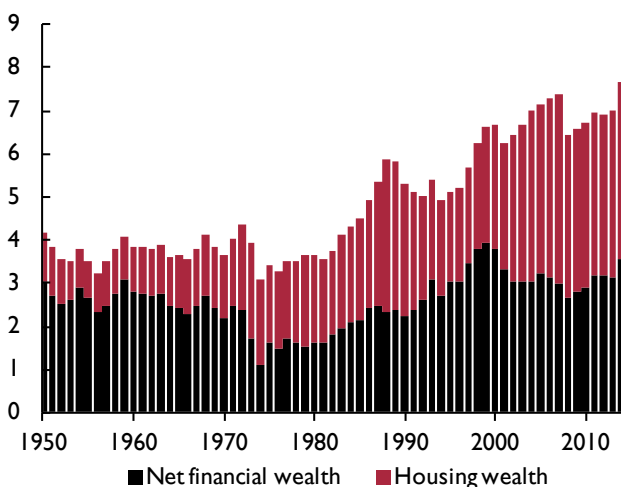
### Intergenerational fairness

There is surprisingly little, if any, credible economic evidence that owner occupation leads to better economic outcomes, such as better education, health, fewer social problems, to mention a few.<sup>4</sup> Owner occupiers are likely to be wealthier and have better outcomes, but there is no evidence this is caused by housing tenure. The evidence that ownership limits labour mobility is also not very conclusive.

Ownership can adversely affect other citizens through intergenerational fairness. The 50 per cent rise in house prices over the past decade benefits the existing owners at the cost of those wanting to become owners. The younger generation, perhaps simply not old enough to own in 2004, now have to save 50 per cent more, or £93,000, from after-tax income just to afford an average UK home. This explains the divergent owner occupation trends noted earlier.

There are parallels between the government debt and house prices. The burden of servicing and repaying the public debt and paying more for housing falls on everyone in future generations. Even those who rent are not exempt; house prices and rents move roughly together. Yet there is a marked contrast in the desire to repay government debt but support housing demand

Figure 1. Personal sector wealth as as share of disposable income



Source: ONS.

and house prices. Over the past decade the increase in public debt was £1 trillion and the increase in the value of dwellings was £1.3 trillion.

### Economic cycles and growth

A second way rapidly rising house prices can impose costs on others is through economic and financial instability. A simple approach to valuing home ownership is the user cost of capital. This adds up the cost of borrowing, essentially the interest charge, plus the cost of wear and tear on upkeep and minus the expected rise or fall in price. If the user cost is less than the cost of renting, then it makes sense to own. When house prices are expected to rise strongly the user cost can fall to zero or even negative.

According to the IMF, housing cycles in the UK have the greatest amplitude of OECD countries.<sup>5</sup> This matters because aggregate demand is highly correlated to house price cycles. A recent Bank of England blog has discussed the correlation between house prices and job losses.<sup>6</sup> The Bank also suggests a link between household debt and the sensitivity of spending.<sup>7</sup> There are disputes about the cause, but no doubt about the correlation. If households are required to take larger mortgages this may increase the amplitude of economic cycles further. The consequences for financial and economic stability are at the heart of the UK's boom and bust history.

Another reason for concern about rising house prices is the consequences for long-term income. Feldstein (1982), using a growth model with different productivity for the housing stock and businesses capital stock, shows that spending on housing may be consistent with slower productivity and lower long-term income.<sup>8</sup> If a greater share of savings is being invested in property, less may be available to support the nation's more productive capital stock. Less investment over the long term results in diminished supply and income potential.

One option is to borrow from abroad to invest in our capital stock. But overseas borrowing needs to be serviced which can ultimately reduce our income. Assuming we do not borrow from overseas, our national savings rate last year of 12.5 per cent and capital to output ratio of 2.2 and a depreciation rate of 4 per cent, implies long-term income growth of 1.7 per cent. Rising house prices can crowd out productive investment.

### Planning and supply

Over the long term we clearly need more housing supply as household formation exceeds new supply. Yet as long

as the government chooses not to build council houses, supply depends mostly on choices made by private sector agents who respond to their own incentives. For all the effort of successive governments to increase supply, the outcome has been disappointing. In 2013, the last year of data, the number of new houses completed was 138,000. This is well below the 177,000 average over the past decade, and the projected 250,000 new households each year over the next decade.

The real question is why supply continues to fall below target. Perhaps the most compelling answer is the planning system. The current government intends to decentralise planning by giving more power to local councils and prioritising the development of so-called 'brownfield' sites.<sup>9</sup> While all governments seek to overhaul the system, with so much wealth in the housing stock there are strong interests of owners or 'insiders' to proceed with caution.<sup>10</sup>

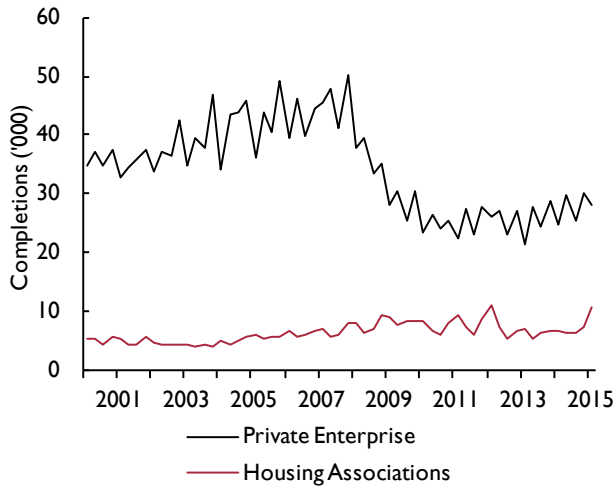
Even if housing supply targets are met this would not solve some the amplitude of cycles. Houses last for around fifty years, so the market is dominated by stock rather than flow of new supply. Assuming supply targets are met, the flow of new houses is less than 1 per cent of the stock. Indeed, if the construction industry were also more procyclical, expanding when house prices are rising, this may even make economic cycles bigger. The US is a cautionary tale of how a more elastic supply of new homes does not ensure lower amplitude of house price cycles.

### Sub-market housing

Some families cannot afford to participate in the private housing market. Housing Associations (HAs) are not-for-profit private organisations that provide rental accommodation at sub-market rates and carry out property development. They fund development from retained earnings and a grant from central government to the tune of around £1bn per year. HAs are the third largest source of housing providing homes to 10 per cent of the population and 20 per cent of new housing supply. The government has extended its 'Right-to-Buy' to HA tenants in the hope that they will replace homes sold with new developments.

In October 2015, the ONS reclassified HAs as public sector corporations. This meant that the government became the country's largest landlord with over 2.8 million families as new tenants and inherited £60bn of new public sector debt. The proximate cause for the reclassification was probably the government's decision to extend 'Right to Buy', which meant that HAs could

Figure 2. Housing completions per quarter



Source: Department of Communities and Local Government, Live Tables 21.

no longer ‘fly under the radar’ as *de facto* public bodies since the Housing and Regeneration Act of 2008.

But this is unlikely to be the end of the story. The government has said it will take whatever actions necessary to reverse the reclassification decision. There is a precedent for re-reclassification: Further Education Colleges were reclassified in 2010 then re-reclassified in 2012. Convincing the ONS will require significant change in the governance of HAs. The problem is that these changes may undermine the funding of HAs and therefore limit the possibility of developing new homes to replace the existing stock.

The HA funding model was surprisingly sound. They receive a steady income stream of social rents and because the government’s claim via its grant is subordinate to private creditor claims this gives investors comfort that their credit risk is limited. Therefore, HAs can aggregate their borrowing and tap domestic long-term investors such as pension funds and insurance companies. As a result, unlike private developers HAs have little reliance on short-term debt.

Figure 2 compares housing supply from private developers and HAs. Private developers’ completions fell by 45 per cent in the crisis period while HA completions rose steadily, providing counter-cyclical support to the economy and the construction sector. This is quite a success for a section of the housing market that is notoriously difficult to fund (consider for example the

sub-prime debacle in the US). HAs may be boring, but their funding structure meant that they have contributed to our economic stability.

The lesson of the re-reclassification of Further Education Colleges is that government may have to relinquish control well beyond the cause of the reclassification in the first place. In other words, government will have to step much further back than simply dropping ‘Right to Buy’ plans. The risk is that the government may have to step so far back from control of HAs that they are no longer able to rely on long-term private funding. This will lead to an even greater share of our housing market being funded by short-term finance.

### Housing taxation

A first priority must be to improve the taxation of housing. At present our taxation of housing is possibly the worst of all worlds. We tax the purchase of houses by stamp duty, which limits the efficient allocation of housing and labour mobility. Council tax has no connection to existing property values. Unlike other assets the income and capital gains on primary residences are untaxed. No attempt is made to tax the excess returns on housing which accrue because of its relatively fixed supply.

An efficient tax system would be consistent across assets and leave the decision about how much to consume today versus save and consume tomorrow unaffected. This is difficult for owner occupiers as the ‘dividend’ or income from their investment is the housing services the household consumes. This suggests a tax on the value of housing services consumed. Further, because of the relatively fixed supply there is a strong case that housing earns an ‘excess return’. An efficient tax system would tax this element, or more likely create an allowance based on a ‘normal return’ and tax any additional capital gains.

If a capital gains tax were introduced, this would reduce the gains in an upturn and losses in a downturn, so dampening house price cycles. This may also reduce the resistance to planning, reduce ‘under occupancy’ and even increase the flow of savings in productive investment. To make such a tax manageable, investment in properties would be exempt and the gains would be paid on final sale or even death. This would avoid any incidence on ‘cash poor’ home owners. The revenue raised could be offset by scrapping the stamp duty transactions tax.

These ideas are unfortunately in the opposite direction to recent policies. Recent changes to inheritance tax limits allow couples to transfer even more wealth in

housing to descendants free of tax. This creates another tax advantage to home owning. Previous governments removed the tax relief on mortgages (MIRAS) without lasting electoral damage. This shows that changing the taxation of housing for the better is possible.

### Housing finance system

A second priority for a better housing market is an effective housing finance system. Housing finance is simple in theory, but difficult in practice. In theory, young households want a long-term loan to fund the purchase of a long-term asset. Middle-age and older households are looking for safe long-term assets to invest in for their retirement. The ideal contract between generations is fixed in real terms, and second best is fixed in nominal terms. Short-term floating rate mortgage debt is third best for both sides.

In practice this is hard to achieve. When the young move house, or when interest rates fall, they pay off the existing mortgage which shortens the duration of pension savings and introduces refinancing risk. Long-term investors have to price non-stationary credit risk (risk falls as the mortgage is repaid) which interacts with refinancing risk. This is all possible, but expensive.

No country in the world has found a satisfactory solution without state involvement. In the US Fannie and Freddie removed residual credit risk (before President Clinton's housing reforms in the 1990s), meaning that investors only had to manage prepayment risk. In Canada the residual credit risk is managed through insurance, where the ultimate insurer of last resort is the state. In Germany the state implicitly supports *Pfandbriefe* (covered bonds) which have not defaulted in over 200 years. Of course the state is also sadly adept at policy failures. But the key point is that in each case mortgages are funded by long-term domestic investors.

House purchases in the UK are almost exclusively reliant on bank finance at short-term interest rates. Housing used to be funded by 'sticky deposits' from building societies. All changed in 1986 when Building Societies were allowed to de-mutualise to increase competition with banks. The funding structure of former building societies either replicated banks or were much worse (like Northern Rock). This was all in the name of greater competition with no thought given to stability issues in finance. As a consequence, housing finance involves a greater maturity mismatch of assets (mortgages) and liabilities (funding) and greater leverage.

Interest rates influence the user cost of capital (discussed above) through mortgage costs and expectations of price appreciation. Mortgages are priced on short-term interest rates which are more volatile than longer-term rates. It is no surprise that our house price cycles coincide with the fortunes of the banking sector. Every downturn in the property markets coincides with serious stresses on the banking system.

As Goodhart and Perotti (2015) make clear, a more stable housing market will require less maturity mismatch and leverage in housing finance.<sup>11</sup> Mortgage supply would be more efficient if funded by long-term sources of finance. Most other countries manage this. It requires leadership in the design of the financial system to meet the economic objectives of the citizens who underwrite the system.<sup>12</sup> The Treasury and Bank of England have the capacity to develop a housing finance system that delivers stable funding and less financial vulnerability.

### NOTES

- 1 See Sinai and Souleles (2005).
- 2 Reported in the *Financial Times*, 15 January, 2016.
- 3 LSL Buy-to-let index (2015).
- 4 O'Sullivan and Gibb (2012).
- 5 IMF (2014).
- 6 <http://bankunderground.co.uk/2015/12/11/house-prices-and-job-losses>.
- 7 Bank of England (2014).
- 8 Feldstein (1982).
- 9 Brownfield is land previously used for commercial purposes.
- 10 Some studies note the increase in the planning and appeals process just as policymakers are trying to shorten it.
- 11 Goodhart and Perotti (2015).
- 12 Armstrong (2013).

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