The British Housing Market

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June 2009

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1. The British Housing Market: What Has Been Happening?

Most people in Britain live in market sector housing, either as owner-occupiers or as tenants in the private rented sector. A relatively small minority live in social housing which is subsidised from the public purse. Over the last decade, the real price of homes in the market sector has more or less doubled. This despite the sharp decline in house prices since mid-2007. (See Figure 1) This is a much more rapid increase than that in real incomes, so housing affordability has worsened dramatically over the same period.

For example, if we measure affordability for first time buyers as the ratio of lower quartile house prices to lower quartile earnings, this ratio has risen in England from 3.5 in 1997 to 7.25 in 2007 before falling back a little in the last two years. Furthermore, rises of a comparable magnitude have occurred in all regions of the UK, although there remain large variations in this ratio, the highest levels being found in the South, the lowest in the North (See Figure 2). So what has been going on?

Figure 1: Long term trend in real UK house prices, Quarter 1 1975 to Quarter 1 2008

![Graph showing long term trend in real UK house prices from 1975 to 2008.](source: Nationwide Building Society)
2. Why Has this Happened?

Around the turn of the century, house building in the UK hit the lowest level since the war although, currently, it is probably even lower. At the same time, the rate of growth in the number of households was rising steadily. For example, in the late 1990s, households in England were rising at around 160K p.a. with house building at around 135K p.a. By the early 2000s, house building did expand but household growth rose even faster, with the gap between the latter and the former averaging around 50K p.a.¹

Figure 2: Lower Quartile Affordability Ratio by Government Office Region

![Lower Quartile Affordability Ratio by Government Office Region](source)

Source: National Housing and Planning Advice Unit

So why has the number of households been rising more rapidly in recent years? The main factors are the significant increase in the rate of net migration into the UK in the late 1990s which contributes around one third of the change, the continuing increase in life expectancy leading to a rapid rise in single person households among the elderly and the steady rise in family breakdown. Single adult households are much the fastest rising category.

So the first major reason for rapidly rising house prices has been a rising gap between household growth and house building. On top of this is the fact that real incomes are steadily growing and
that richer people tend to demand more housing services. The historical evidence suggests that the income elasticity of demand for housing exceeds the price elasticity of demand. This implies that as real incomes rise, house prices will rise more rapidly than incomes even if there is a perfect match between house building and population growth.

These have been the basic driving forces behind the house price boom but, in addition, we have seen historically low borrowing rates since the turn of the century. The fundamental factor here has been the world-wide decline in long-term real interest rates from around 4% in the mid 1990s to less than 2% in the 2000s. This has been caused by the excess of savings generated by the far Eastern economies as well as by the oil producing countries. On top of this, fierce competition among mortgage lenders, with ready access to these savings using the money markets and mortgage backed securities, led to easy access to credit by borrowers. This factor can, however, be overstated. For example, the average loan to value ratio of first-time-buyer mortgages was significantly lower in the period after 1998 than it was in the previous decade (See NHPAU, 2009a). So the deposits demanded of first-time-buyers during the housing boom were higher, on average, than they were previously. A potential fourth factor was the increase in incentives to invest in residential property driven by the sharp decline in equity markets in 2000-3, prospective capital gains and the increasing use of Buy-to-Let mortgages. This has led many commentators to argue that there has been a housing market bubble but the most complete analysis, to be found in Cameron et al. (2006), suggests that the rise in house prices is mostly consistent with the fundamental forces noted above and that there has been only a very modest bubble, at worst.

3. Recent Events in the Housing Market

From mid-2007, the housing market in the UK experienced a sharp downturn. House prices started to fall, are still falling and are expected to fall further. Since house building still lags far behind the increase in the number of households, what has happened? Basically, there has been a collapse in the availability of mortgages, particularly to first-time-buyers. This has come about because the mortgage lenders are now more or less cut off from the money markets. A generalised lack of trust in mortgage backed securities, initiated by the sub-prime crisis in the U.S., has meant that the mortgage lenders now find it very difficult to access the continuing
world-wide glut of savings because they are unable to use their mortgage assets as collateral. Since domestic retail deposits are not large enough to fund the flow of new mortgages required in a properly functioning UK housing market, mortgages are now severely rationed especially for first-time buyers, with a 60 per cent fall in new mortgages for this group. This led to a sharp fall in the demand for housing, a fall accentuated by the very fact of declining house prices leading to first-time-buyers holding back from the market. Nevertheless, the number of people wanting to buy houses remained relatively buoyant but since many could not raise a mortgage even if they were excellent credit risks, this desire could no longer be acted upon. The consequence was even more rapidly falling house prices, house builders unable to sell their new homes and a collapse in new housing investment with strongly adverse consequences for the wider economy. This, along with the wider consequences of the collapse in the availability of credit, generated a very sharp recession which remains with us at the time of writing. As a result, the demand for housing has fallen even further. This situation contrasts with the decline of the housing market in the early 1990s which was a consequence of a recession in the UK and rapidly rising unemployment. It is often suggested that the significant fall in house prices has generated a situation which is excellent news for first-time-buyers. In fact, this news is far from excellent because first-time-buyers are now locked out of the housing market because they are unable to obtain a mortgage without providing a very large deposit. Were access to the mortgage market to revert to the normal state which ruled in the twenty five years prior to 2007, a flood of first-time-buyers would try to buy homes and prices would simply start rising again.

4. So What are the Prospects for the Future?

Sooner or, more likely, later, the recession will evaporate and the mortgage market will recover. The underlying forces driving housing demand upwards are projected to continue even more intensively over the next decade than they have done in the recent past. Household projections for England, based on the revised 2004 ONS Population Projections, suggest an average rate of increase in households of around 230K per annum up to 2020. Since the latest 2006 ONS Population Projections are considerably higher than those generated in 2004, it seems quite likely
that the number of households will grow even more rapidly. Of course, the recession is likely to lower net migration in the short run, so it is possible that household growth will slow for some years. But over the longer term, the number of households is likely to grow even more rapidly than in the recent past. So this rate of increase will be considerably higher than the 200K per annum since the turn of the century and far higher than both recent rates of house building and current housing plans set out in the Regional Spatial Strategies. In the light of this, given that real incomes are also expected to grow in the longer term, house prices will keep rising relative to incomes in the long run provided that the mortgage market returns to normal and first-time-buyers have reasonable access to credit. (See National Housing and Planning Advice Unit (NHPAU), 2008, 2009 for some recent projections). Of course, while the mortgage market remains highly restricted and the UK economy remains in recession, house prices will continue to be depressed. But lower levels of house prices generated by a mortgage famine and an economy in recession is no real solution to the long-term housing shortage and consequent affordability problem. For where are all the additional households supposed to live? The only serious way to resolve this problem is to generate higher rates of housebuilding. Under existing structures, this seems unlikely to happen.

5. Does it All Matter?

When house prices rise relative to incomes, property owners gain relative to the rest of the population. Non-property owners will have to spend a higher proportion of their incomes on somewhere to live via increased rents or increased mortgage costs. Basically, there is a large transfer of wealth from the young and the poor to the old and the wealthy. It is not clear that the former are less deserving than the latter and most would judge such a wealth transfer as socially undesirable.

More practically, as house building fails to keep up with increases in the number of households and prices rise relative to incomes, more people are driven into the private rented sector, driving up rents, and into the social renting sector, driving up waiting lists. Thus, between 2002 and 2007, there was a rise of over half a million households on the housing register compared with an increase of only 73 thousand between 1998 and 2002. Furthermore, despite falling house prices,
the demand for social housing is currently increasing still more rapidly. Overall, deprivation increases and the situation worsens in already deprived areas. There is more overcrowding and people are generally less well housed. Many key workers, such as nurses and teachers, are unable to find somewhere to live near where they work. All these problems increase the pressure for the spending of taxpayers’ money in order to attempt to alleviate them. This is unlikely to be forthcoming, in part because the sums required are huge. To provide social housing for the extra half a million households on the housing register noted above would cost £50 billion at £100K per household, close to 4% of GDP. This suggests that the only solution is to increase the rate of house building for the market sector, making market housing cheaper relative to incomes, allowing more people into the market sector and reversing the process described above. Simply building more social housing just will not work, since it will never be done fast enough. Allowing more market housing to be built works because it reduces the demand for social housing.

6. Policy Issues

6.1 A Little History
The history of house building in England is encapsulated in Figure 3. Since the peaks of the 1960s, private sector house building has fallen somewhat but the rate of house building for social renting has more or less collapsed. In the 1960s and early 1970s, Local Authorities were building at the rate of more than 100 thousand dwellings per year. Currently, houses for social renting are coming on stream at less than 30 thousand per annum. Far less public money has gone into this sector since the mid 1980s and this has not been replaced by greater investment in private house building.
The planning system has been the main binding constraint on private house building. Restricting the supply of building land in the face of rapidly rising demand for housing has been a major factor in driving up house prices which are reflected in the extremely high values attached to building land, particularly in the South (see Figure 4). In much of the South East, building land in 2007 fetched £5 million per hectare, around 3 or 4 hundred times the price of the same land for agricultural use. This shows what rationing can achieve.
6.2 Why did this happen?

After the war, public support for house building and development was widespread. During elections, political parties vied with each other in the grandiosity of their building plans. By the 1990s, this public support had evaporated. Concerns over the environment, the countryside, infrastructure, sustainable development and simple NIMBYism meant that the majority of people were not in favour of development, particularly in the South where increasing numbers wished to live following economic development.²

The impact of restricting the supply of land for house building did not emerge on the political agenda until the early 2000s, in part because the majority of people were benefiting from the house price boom and they were the older and richer members of society who carry more political weight in any event.
The Local Authorities, who control the supply of land for house building, have also seen a reduction in their incentives to allow development more generally. Their loss of control over, and direct access to, business rates and their overall loss of power in the 1980s were important in this regard. The upshot of all this was that, as we have already noted, by the turn of the century, fewer dwellings were being built in the UK than at any time since 1950 (see Figure 3).

By 2003, the Government recognised that the social and economic consequences of rapidly rising house prices and increasing numbers of less and less well housed individuals were problems to be addressed. They commissioned Kate Barker to write a report on housing supply (Barker, 2004) and, as a result, set about adjusting the planning regime in order to increase the supply of housing. A good summary of their ideas may be found in the Housing Green Paper (CLG, 2007).

6.3 Where are we now?

The basic mechanism by which central government, at least in England, attempts to influence the rate of house building is of the “command and control” type. There are general rules governing new developments, such as the high proportion of new build on Brownfield as opposed to Greenfield sites, with the houses being built at relatively high density. Then each region has to put forward a “Regional Spatial Strategy (RRS)” along with local development frameworks. These RSSs set out the numbers of new houses to be built over a plan period along with an overview of where they are to be located. The latest planning guidance (Planning Policy Statement 3, PPS3) has a strong focus on ensuring an adequate supply of land for housing, in particular insisting that the prospects for market housing affordability must be taken into account in the planning process. Advice on affordability prospects is provided by the National Housing and Planning Advice Unit, a Non-Departmental Public Body. This body is also charged with providing advice to the Government on the ranges of housing supply to be considered by the Regional Planning Authorities when the RSS plans are reviewed (see NHPAU, 2008a, for the latest such advice). By and large, since 2003 we have seen a sequence of plans, targets and advice indicating a desire to build an ever increasing number of houses, at least in part because official projections of household growth have been steadily rising over this period.
On top of this, there are a number of special policies involving further house building, notably plans for the Thames Gateway, ten new Eco-Towns and growth points. All these involve more or less continuous interaction between Local Authorities, Regional Assemblies, Regional Development Agencies and Central Government (Department of Communities and Local Government). This involves huge expenditure of time and energy which is accentuated by the fact that Local Authorities have little in the way of financial incentives to encourage house building in their locality. For example the Lyons Report on Local Government (Lyons 2007) is much concerned with “providing financial incentives for Local Authorities and communities to promote economic prosperity and residential growth ….”

The consequences of this command and control system are often perverse. For example, the encouragement of Brownfield, high density building in England has led to very significant increase in the proportion of new build in the form of flats, a significant reduction in the proportion of family homes and the gradual disappearance of back-gardens in urban areas. This despite the fact that family homes with back-gardens are precisely what most households desire. But, overall, the key fact remains that unless Local Authorities have significant financial incentives to encourage development, no amount of command and control is likely to produce enough new homes to allow people in the UK to be properly housed.

6.5 Incentives for Local Authorities

Financial incentives for Local Authorities to allow development are not totally absent. At present, however, they have very little in the way of access to the “planning gain” which typically arises from the granting of planning permission. So what sort of financial incentives currently exist? The obvious general incentive is that arising from the fact that the Central Government grant, which covers the vast majority of Local Authority expenditure, is increasing in the relevant population. Thus more housing means more people means more money. The problem here is the delay because there is a long lag between the time the extra people arrive and the point when the extra money starts to flow. On balance, this probably serves as a disincentive to allowing housing development. There are, however, a number of schemes, some existing and some proposed, which generate modest positive incentives.
Section 106 payments
These are made by developers to Local Authorities as a condition of planning permission. The idea is for the Local Authority, in return for granting planning permission, to negotiate some community benefits such as infrastructure and open space, as well as the proportion of low cost homes in the development. Since there has to be a separate negotiation for each development, the transaction costs are enormous and the sums generated are typically only a small proportion of the planning gain.

Housing and Planning Delivery Grant (HPDG)
This is a reward payment to Local Authorities that “meet their agreed development time tables for new housing, based on the requirements set out in PPS3”. Thus it rewards the delivery of new housing and the identification of at least five years worth of sites. Overall, however, the amounts are small and not likely to generate strong incentives.

Community Infrastructure Levy (CIL)
This is proposed but has yet to be introduced. Originally, the notion of a tax on planning gain was floated, known as “planning gain supplement”. This was discarded as involving too much negotiation and being too costly to collect. The CIL allows the Local Authority to apply a levy (per roof or per square metre) on all new developments in order to fund new infrastructure. The Local Authority assesses infrastructure requirements and, after consultation, publishes a charging scheme with the levy being paid at the outset of development. The incidence of the tax is on the landowner and it must obviously differ between areas and between Greenfield and Brownfield sites. The existing plan is that the revenue cannot be used for general expenditure nor to remedy existing infrastructure deficiencies.

The basic problem facing Local Authorities, particularly in the South where housing demand is highest, is that the majority of their constituents are opposed to new development. So what they need is to generate enough money from new development to fund local improvements in services and the urban environment which will enable them to show the demonstrable benefits of new development to their constituents. The CIL could potentially operate in this way but, in the
current proposal, the Local Authority is constrained to restrict expenditure to the provision of the infrastructure required by the new development and nothing else.

Overall, therefore, we have a system which has no real prospect of getting Local Authorities to be strong supporters of new housing development in the quantities required and in the places required (mainly the South) to house people properly. Without Local Authority support, it is unlikely that any amount of command and control from Central Government will succeed in generating the supply of new housing that is required.

7. Prospects for Policy
In the light of the previous discussion, what policy changes might be helpful in ensuring that citizens are better housed than they are likely to be under existing arrangements? Responsibility for planning has to remain at local and regional level, and while we continue to have Regional Development Agencies, they must also be involved. One of the basic problems is the fact that there are strong forces driving economic development towards the Southern half of the UK. Economic development means jobs, people follow jobs and demand for housing follows people. Generally speaking, the activities of the Regional Development Agencies are not able to resist these trends. So restricting housing development in the South means higher house prices in the South, increased commuting, labour shortages and restricted economic development overall. On pure economic efficiency grounds, restrictions on housing development should be removed and Southern towns would expand dramatically. This is the scenario envisaged in Leunig and Swaffield (2008). While this is a practical possibility, it seems unlikely, at the moment, that it would garner any strong political support.

Nevertheless, if we are to have people better housed, the planning system has to ensure that houses are built in places where people want to live. And house prices, and hence the price of development land are valid signals in this context. In order to inject these signals into the planning process, we should allow Local Authorities to access the planning gain from allowing development in a simple and systematic fashion. This suggests the following possible changes to the existing arrangements.
i) Reduce the extent and detail of the existing command and control framework including the elimination of Section 106 payments and the Housing and Planning Delivery Grant as well as relaxing the rules on Brownfield development and density.

ii) Use the Community Infrastructure Levy system to provide strong incentives for Local Authorities to favour housing development. This implies allowing CIL incentives to work, so that the rates can be higher in areas where the difference between the value of land with planning permission and its alternative use value is higher. The idea is to enable Local Authorities to extract a much higher proportion of the planning gain than is currently the case and to allow them to spend it on improving the lot of their constituents more generally, including the provision of subsidies to social housing. The planning rules about housing mix could be incorporated into the system. Or, perhaps better, instead of reverting back to Section 106 type negotiations about affordable housing, the Local Authorities could simply use CIL funds to ensure the supply of affordable housing on their own account.

The general idea underlying this strategy is that instead of engaging in endless negotiation with developers, Local Authorities would simply tax developments, with the burden of the tax falling on development land prices. The Local Authorities would then use the money as they see fit.

iii) The recent Conservative Party proposals (see Conservative Party, 2009) suggest that Local Authorities receive a grant from central government which matches the council tax taken for each new house built for six years. While this plainly generates a significant incentive for new development, it involves an increase in government expenditure and makes no attempt to capture the planning gain. There is also a proposal to abolish the regional planning system and regional housing targets. This eliminates any mechanism for co-ordinating development across neighbouring Local Authorities.
iv) A more speculative alternative to the CIL system is that proposed in Leunig (2007). Here the Local Authority invites offers of land from landowners, that is landowners state the price at which they would be happy to sell their land (in a sealed bid). The Local Authority then chooses which of this land they would like to see developed, buy it at the offered price, grant planning permission and then auction this land to developers. The Local Authority keeps all or a high percentage of the money which may be used to enhance local services and facilities, to provide infrastructure and to subsidise social housing.

8. Conclusions
The current system of planning and development in the UK generates new homes at a rate which has been well below the rate of increase of households for many years. This has helped to generate very rapid increases in house prices relative to incomes in the last decade as well as rapidly lengthening waiting lists for social housing. The fundamental problem has been the severe rationing of land for new house building by Local Authorities as they respond to opposition to housing development on the part of their constituents and the absence of any significant final incentives to encourage development. Our policy proposals are geared to alleviate the situation by allowing Local Authorities to access the large financial gains accruing to landowners consequent on the granting of planning permission. The money can then be used to subsidise social housing and improve the locality more generally.

Of course, the ultimate decision on whether people in the UK are properly housed is political. And there is much political opposition. But most other rich countries seem to manage to build far more houses relative to their populations then we do in the UK. So it should not be that difficult.

Endnotes

1. Net additions to the housing stock, which includes conversions of existing buildings, expanded somewhat faster than house building, but this was, and remains, slower than the increase in households.
2. A good survey of the emergence of these ideas may be found in Barker (2007).

3. Brownfield sites are those where development has already occurred. These would include back gardens as well as old factory sites and the like.

4. It was proposed in the Barker Review and appeared in the 2007 Green Paper.

5. Of course, there is a limit to the tax in the sense that if it is so high that the development land price falls below the value of the land in its alternative use, then no development will occur. It is also worth noticing the push in the direction of zero carbon housing. The cost of this will also be a charge on the planning gain which will further limit what can be raised via CIL. In practice, instead of pushing towards zero carbon on new properties, a much bigger and more cost effective impact on carbon emissions could be achieved simply by providing free loft insulation to all existing properties, in part funded by CIL.

References


