UK Housing Market: Problems and Policies

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The *Commentary* of this edition of the National Institute Economic Review no 235, Dr Angus Armstrong looks at the problems in the UK housing market and considers fundamental reforms to housing taxation and housing finance.

Housing is at the top of our political agenda, necessarily so for the security and well-being of our families. However, there is mounting evidence that we are failing to deliver decent housing, especially for the younger generation. More houses are being bought for investment purposes, raising the costs of housing; the older generation are "under-occupying" (even "hoarding") property; the number of new homes being built is lower than the number of new families; and the re-classification of housing association property may make this sector less able to access long-term stable funding.

- **Home ownership trends and investment returns**

Housing is the most important asset we own, accounting for 58 per cent of the entire net wealth of the UK. 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. 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.

- **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. Ownership can adversely affect other citizens through intergenerational fairness. The 50 per cent rise in house prices over the past decade benefit 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.

- **Economic cycles and growth**

A second way rapidly rising house prices can impose costs on others is through economic and financial instability. According to the IMF, housing cycles in the UK have the greatest amplitude of OECD countries. This matters because aggregate demand is highly correlated to house price cycles.

- **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. The real question is why supply continues to fall below target. Perhaps the most compelling answer is the planning system. However, even if supply targets are met, 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. In October 2015, the ONS reclassified HAs as public sector corporations. The proximate cause for the reclassification was probably the government's decision to extend 'Right to Buy'. However, this may be reversed with the risk 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. 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. 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. These ideas are unfortunately in the opposite direction to recent policies.

- **Housing finance**

A second priority for a better housing market is an effective housing finance system. No country in the world has found a satisfactory solution without state involvement. House purchases in the UK are almost exclusively reliant on bank finance at short-term interest 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.

A more stable housing market will require less maturity mismatch and leverage in housing finance. 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. The Treasury and Bank of England have the capacity to develop a housing finance system that delivers stable funding and less financial vulnerability.

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Notes:

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