A housing failure: it’s not more rental stock we need; it’s more of the right kind of houses

Posted by Paul Cheshire, LSE & SERC

The RICS recently called for a big boost to building houses specifically for rent because, they claimed, there will be an additional 1.8 million household looking for rental property by 2020. This misses the point and will not address the causes of our housing crisis. Our problem is not a shortage of rental housing; it is a shortage of housing - full stop. All houses are owned and occupied, vacant or rented and renting is a substitute for owning. As a result the long run rents and prices tend to move more or less in step for a given type of house. But we have not only a shortage of houses but an unbalance offer of houses. They are on average too small, not well enough designed or built, and in the wrong locations. That is cramped houses in places people do not really want to live. But because there is such a shortage both prices and rents have been rising consistently in real terms for two generations.

My LSE SERC colleagues and I have been generating the evidence of this shortage and identifying its causes for years now (see here, here, here or here). The uncomfortable reality is that the total unfitness for purpose of Britain’s planning system and how that interacts with our system of local taxes seriously restricts the supply of new housing. This reality is somehow too disconcerting to confront. Politicians offer magic wands to build 1 million homes by 2020 or 55,000 a year in London but deliver no mechanisms to achieve it. They know that politically they cannot say they do not want to build more houses but they feel incapable of tackling the vested interests benefiting from both the causes of our desperate housing shortage and its results.

In 2014 my reasonably informed estimate was that the accumulated house building shortfall in the 19 years to 2012 was between 1.6 and 2.3 million homes. The problem is long term, not short term. We should not be London-centric but to illustrate with London: we were building around 75 to 80,000 houses a year in the GLA area in the 1930s; nearly 30,000 a year even in the 1870s. But since 1980 house building in London has only occasionally reached 20,000 a year. The only effect of raising ‘targets’ since 2000 – up progressively from 14,330 to now 55,000 – has been to increase the shortfall between promise and achievement. And given his policies Sadiq Khan will be no more successful at delivering on his targets than Boris Johnson was his.

House prices have roughly doubled in real terms in every decade since the 1950 and since 2005 have risen by 47.4%. But over this more recent period rents ‘only’ rose by 18.4%. This is not a ‘long period’ – the one in which we are all dead – but still the close link between prices and rents seems to have weakened.

Houses are a peculiar form of ‘good’ because they perform two functions at once. They provide a flow of housing services; they are places to live. But they are also investment assets. In a world of stable prices a sensible person would choose whether to own or rent on the basis of their circumstances and preferences. They might be young and mobile so want not to have the fixed costs of ownership. Their hobby might be do-it-yourself so they would want their own house to perfect. They might be scholars or inveterate travellers who did not want the ties of home ownership. From the investors’ point view they might want something like a ‘bond’: a safe and secure asset, albeit not very liquid, providing a more or less guaranteed flow of income in the form of rents.

This world of stable real house prices is not an economist’s fiction. It is more or less the situation in Germany or Switzerland. Those countries have pre sensible planning and local tax systems and they build enough houses to satisfy demand. Britain is, of course, different. We have a dysfunctional planning system and an almost equally dysfunctional system of taxes when it comes to land and housing. So both housing but even more land to build houses on, are in short supply and have been in increasingly short supply since we started to ration space by imposing Green Belts in 1955. Getting permission to build houses on a hectare of farmland on the northern fringes of London would increase its price from perhaps £20,000 to £12 to 15m: a clear signal of the loss of value imposed by not letting more people live where they really want to and could be most productive. So if you live in a work planned on British (as opposed to German or Swiss) foundations, a world in which the real price of houses nearly doubles in every decade, then of course you have a big incentive to be a home owner. Miss out at 25 and you risk permanent exclusion from the housing wealth ladder provided by our ever rising house prices. Home ownership as a tenure steadily rose from 32% in 1953 to around 70% in the early 2000s, but has now dropped back to less than 64%. For people born in the 1950s the homeownership rate nudged above 70% before they got to 34; in the past 12 years, however, homeownership rates for the under 34s have fallen from 59% to 34%. Younger people have been priced out of ownership, even become YIMBYs. This growing out of ownership partly results from the ever rising price of houses relative to incomes but even more from the large real increases in the cost of living that have significantly offset that hurdle as the large real increases in the cost of living that have significantly offset that hurdle.

The growing hurdle for the young would-be home owner has just been getting a deposit together; especially in the face of competition – prices have all risen relative to rents – from the fortunate cohorts born in the 1950s or 1960s withdrawing equity to get a buy-to-let as a pension. The median landlord only owns one rental property but given what has happened to returns on other assets, if you want a bit of income, letting out has become seriously attractive. So would-be owner occupiers have been squeezed out by wannabe landlords whose incentive is the extraordinary low returns on those assets normally financing pensions and the capital gains they have made and expect to make from owning homes in a market like Britain’s. This pushes up house prices but increases the supply of rental stock.

The problem is that unless we really step up house building all we do is redistribute an almost fixed stock between alternative buyers: buy-to-let landlords or owner occupiers or just a few second home owners – British or foreign – who do not occupy their houses very much. We do not need to build more rental stock; we need to build more homes.