The Future of Private Renting

Shaping a fairer market for tenants and taxpayers

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Summary

- The private rented sector is growing as a proportion of the UK's housing stock, with greater numbers of people forced to rely on it as house prices rise and social housing declines. It is expected to account for more than a third of the UK's housing stock by 2032.

- The cost of private renting has risen out of proportion to wages, meaning it is becoming increasingly expensive for tenants and, via the housing benefit bill which is used to subsidise rents for people on lower incomes, the general taxpayer.

- Housing benefit has an inflationary effect on rent levels, at least at the lower end of the market, making matters worse. In some local sub-markets with high numbers of claimants, the effect of this is particularly acute, with landlords able to set rents at artificially high levels in line with the Local Housing Allowance.

- The security of tenure available from private landlords, usually of just six or twelve months, is inadequate for families and those shut out of owner-occupation and social housing who are increasingly having to make their home in the private rented sector.

- The housing shortage has not been alleviated by the growth in the number of properties in the private rented sector, which has mainly expanded through the purchase of existing stock rather than new-build. This has contributed to house price inflation, which is preventing many private renters moving into owner-occupation.

- A new regulatory framework should be considered that would curb future rent growth and improve security for tenants. This should include indefinite tenancies within which rents (freely negotiated at the outset between landlord and tenant) would only be allowed to rise in line with a measure of inflation.

- In order to encourage investment in new housing, new-build properties would be exempt from this regulation, but landlords would be encouraged to enter voluntary longer-term arrangements with tenants where this is mutually attractive. Institutional investors might be particularly receptive to such a framework.

- A wider range of incentives for investment in the private rented sector, other than the attractions of a highly-deregulated market and the prospect of capital

gains through house price inflation, should be considered. These could be used, if the further expansion of the private rented sector is thought to be desirable, to encourage longer-term investments and ones that contribute to housing supply.

Introduction

The private rented sector, which has undergone a remarkable renaissance over the past two decades, is becoming increasingly central to considerations about the housing market and the benefits system. Four million homes are now privately rented in England, accounting for 18 per cent of all households. The sector has doubled in size since 1989 and contains more households now than social housing. Owner-occupation is in decline.[1]

This trend has been accompanied by another, directly related, development: the rapid rise in the housing benefit bill, which has more than trebled in real terms over the same period and is now in excess of £24 billion across the UK. Within that, the amount claimed by those renting from private landlords (as opposed to local authorities or housing associations) has also shot up, more than doubling over the past decade to £9.5 billion. It is expected to top £10 billion by 2019. A quarter of private tenants now claim housing benefit to help meet the rent.[2]

These sums reflect the worsening affordability of private rented accommodation which growing numbers of people have no choice but to use, owing to the decline in social housing and barriers to home ownership. As well as the cost of renting, another issue that has come to the fore with the increasing reliance on private landlords has been the lack of security offered to tenants who want long-term stability, particularly those with children.

There is no solution to the current housing crisis that does not involve a dramatic increase in the construction of new homes, including in the social sector. But that does not mean that nothing can be done to alleviate some of the associated problems until such time, if it ever comes, that scarcity ceases to be a defining characteristic of the housing market. Because even in the best case scenario, over the coming years house building is only slowly going to catch up with demand, if it ever does, so the cooling effect that should have on prices is some years hence. In London, moreover, it is quite conceivable that supply will never match demand, such are the space limitations and the seemingly limitless allure of the capital to newcomers and investors from around the world.[3]

So this paper does not seek to provide a solution to the housing crisis in its entirety but to study those measures designed to provide a safety net for lower-income households in particular *while* there is a shortage of affordable property. There will always be a proportion of households at the bottom of the income scale who require state support to keep a roof over their heads. That safety net is essential in any civilised society. The question is how best to provide it. The proposal offered here is intended to start a process in which demand subsidies in the form of housing benefit, currently growing in size and influence in the housing market, are gradually scaled back. It attempts to address together the issues outlined above through a system of indefinite leases and rent ceilings within (but not between) tenancies.

Any attempts to interfere in market prices arouses suspicion, and justifiably so. However, it is the argument of this paper (set out in Chapter 3) that private sector rents are already distorted – upwards – by a system of subsidies that places a floor under prices, at least at the lower end of the price spectrum. This in turn increases the numbers of lower-income households forced to rely on it, further inflating rents. In the context of this vicious circle a system of rent regulation would be justified, to curb further inflation in the cost of private renting and so limit the numbers of additional people dragged into housing benefit dependency.

Critics argue that any form of price regulation will make the present situation worse by reducing investment in the private rented sector and reducing the supply of homes. It is said that the sector must be supported to grow to accommodate the increasing numbers of people shut out of the housing market. However, the rapid expansion of the private rented sector has not led to any significant growth in the number of homes available; it has been achieved at the expense of the owner-occupied and social sectors, which have been shrinking. As a result, the private rented sector has contributed to much of the demand it purports to meet (see Chapter 2). It is supported in this by a housing benefit regime which provides a financial safety net for landlords as much as for tenants.

It should not be assumed, in any case, that modest restrictions on rent rises will create an exodus of investors from the private rented sector. Many of those investors have bought homes to let in pursuit of capital gains as much as rental yields. House prices are expected to continue rising, so that incentive will remain on offer, probably until the shortage of new constructions is finally dealt with – if it ever is. Those who point to the decline of the private rented sector prior to deregulation in the late 1980s should consider the many other factors that drove landlords out of the market over the course of the twentieth century. Government policies to expand owner-occupation and the provision of municipal housing were at least as important in that decline, and encompassed much more than just rent controls (see Chapter 4). The lesson from those years, and from the experiences of other nations with much larger private rented sectors than the UK, is that the health of the sector is determined by a wide range of economic conditions and government actions that inevitably includes, but is not limited to, the regulatory framework. Given that the UK currently has one of the most liberal regimes internationally for private landlords, policymakers should consider the wider investment environment more carefully before dismissing the scope for indefinite tenancies and rent regulation. It should also seek where possible to ensure that the private rented sector, if it is to expand further (as seems inevitable), plays a bigger role in supporting the building of new homes.

The longstanding policy of subsidising demand rather than supply – dating largely from the 1980s where rent controls were abolished, too – has led to many of the problems afflicting housing provision in the UK today. It should be the goal of government to reverse this balance, in time. One of the first steps must be to curb future increases in private sector rent, so that fewer people come to rely on housing benefit and so that those who do need less of it. This paper explores how we might do that without the disruption that is engendered by merely cutting and capping housing benefit payments. Only by gradually reducing the influence of housing benefit can we achieve a fair market in housing – a market that promotes supply rather than choking it off, and forces landlords to compete on price and quality rather than too often taking desperate tenants for granted.

Chapter 1: Background – the rejuvenation of private renting

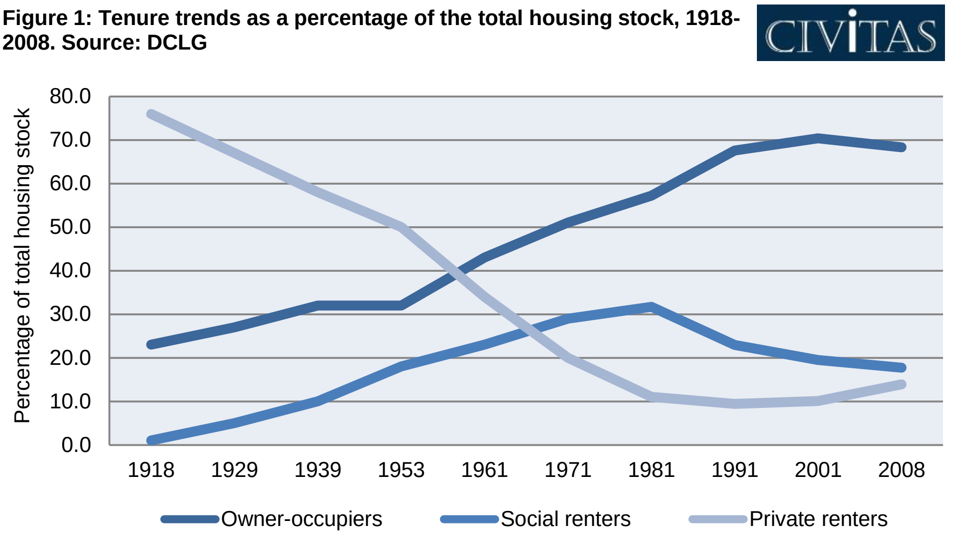
There are more households renting from private landlords today than at any time since the 1960s.[4] Four million homes were privately rented at the time of the most recent English Housing Survey (2012/13), accounting for almost one in five households, as a result of the dramatic growth in the sector over the past quarter of a century. Until the early 1990s, the story of private renting was one of long-term decline, from representing 76 per cent of households (in England and Wales) in 1918 to a low-point of just 9 per cent in 1991. This decline corresponded with the huge rise across the century in both home ownership (from 23 per cent in 1918 to 69 per cent in 2001) and social renting (from 1 per cent in 1918 to a high point of 31 per cent in 1981).[5]

Private renting has rebounded since the late 1980s and early 1990s, increasing as a proportion of the housing stock to 12 per cent in 2001 and then 15.3 per cent in 2011. The trend continues, with the English Housing Survey (excluding Wales) putting the figure at 18 per cent for 2012/13[6] and estate agents forecasting the sector will grow significantly faster than the total housing stock in the years ahead.[7] Correspondingly, owner-occupation is now in decline, falling back to 64 per cent in 2011 after its first ten-yearly fall since it began to expand after the First World War.[8] The number of homes in social housing has been shrinking since the early 1980s and now accounts for a smaller proportion of the housing stock in England than the private rented sector.[9]

The stage was set for the expansion of private renting with the passage of the 1988 Housing Act, which scrapped rent controls and introduced shorthold tenancies to make the sector more attractive to potential investors. These reforms were followed by the introduction of buy-to-let mortgages in 1996 which made it very much easier for small investors to buy property for private rental. A few years later, in 1999, there were 73,200 outstanding buy-to-let mortgages, with a combined value of £5.4 billion. The industry was given increased momentum by the house price boom of the late 1990s and 2000s, and by 2011 there were 1.39 million buy-to-let mortgages worth £159 billion.[10] The result was a near-doubling, in the space of a decade, in the number of homes owned by private landlords – from 1.9 million to 3.6 million between 2001 and 2011.[11]

There are compelling reasons for supporting a thriving private rented sector, not least in providing choice for tenants and greater competition in the lettings market, which was for many years dominated by local authority provision. In economic terms, a strong supply of good-quality and affordable rented accommodation is essential to support the mobility of workers, particularly those in the early stages of their career, with a degree of flexibility that owner-occupation and social housing cannot.[12] This is true not just for British citizens moving between towns and cities but for the increased numbers of migrant workers who have come to the UK over the past decade. The growth in the student population, reaching 2.5 million in 2012,[13] has also fed the demand for private rented accommodation.

Figure 1: Tenure trends as a percentage of the total housing stock, 1918-2008. Source: DCLG



However, it would be a mistake to assume that the growing numbers of people entering private rented accommodation are all doing so for lifestyle reasons. There are many in the sector who would rather own their own home. The latest English Housing Survey reports that, while 84 per cent of private renters were 'satisfied' with the actual accommodation, only half (52 per cent) thought their tenure was a good one. (Among owner-occupiers, 93 per cent liked their tenure, and even among social renters the comparable figure was 82 per cent.)[14] Data drawn from the 2010 British Social Attitudes survey shows that 86 per cent of the public would most prefer to buy a home, and even 68 per cent of renters would prefer to buy.[15] But high house prices and lack of credit since the 2008 financial crisis have been barriers to first-time buyers. Savills, the estate agent, estimates 200,000 would-be buyers have been shut out of the market every year since 2009, a trend it expects to continue for the next five years.[16]

While owner-occupation is becoming increasingly difficult to attain, so is social housing. Having grown in provision throughout most of the twentieth century, that has been shrinking as a proportion of the housing stock, partly as a result of the sale of local authority homes and the failure to invest in replacements. While almost two million council tenants grasped the opportunity of becoming home owners under Right to Buy,[17] those who could not afford to buy a home became steadily more reliant on private landlords (in whose possession, incidentally, a third of Right to Buy homes have ended up).[18]

While the private rented sector is nowhere near the size it was at the beginning of the twentieth century, it is growing again and occupying an increasingly important place in housing provision. This growth is set to continue, with predictions that, by 2032, owner-occupiers will be in a minority with the private rented sector accounting for more than a third (35 per cent) of the housing market.[19] This trend brings with it new challenges which need to be addressed.

Chapter 2: Costs and consequences of the new housing landscape

The recent expansion of private renting was preceded by the almost complete deregulation of the sector. This has given landlords in the UK much greater freedom to raise rents and evict tenants than they would have in many other countries with bigger – and well-functioning – private renting markets (see Chapter 4).

The free rein given to landlords since the end of rent controls, combined with the effects of the housing shortage, has led to concerns about the affordability and security on offer to tenants who increasingly have little choice but to enter private rented accommodation.

Housing costs too much for too many people

Despite, or because of, the growing reliance on private lettings, it is too expensive for an increasing number of people to afford. This problem is growing as the private rented sector expands, as the latest English Housing Survey explains: 'Affordability of housing is becoming an increasingly important issue. Private sector rent levels are higher than in the social rented sector and… the size of the sector is growing, meaning that affordability of rent may be an issue for more households.'[20]

Rent now costs private sector tenants on average 40 per cent of their household income, which is for more than two-thirds of them less than £700 a week.[21] By contrast, owner occupiers, buying with a mortgage, spend 20 per cent of their income on their mortgage and social renters 30 per cent on their rent. There are some who argue that rent regulation would be tackling a problem that does not exist as rents are – or have been - rising by less than inflation[22]. On average, across the nation, and even region by region, this might be the case,[23] although there is evidence that they are at the very least creeping ahead of CPI[24] and possibly even soaring ahead of prices.[25]

But there are two points to consider here. One is that the average is not what most people actually experience. The growth in private rents is 'markedly higher' in London than any other region,[26] and in some residential pockets rent inflation has been phenomenal. Consider commuter areas like Surrey Heath and Elmbridge, which have experienced inflation above 14 per cent in one year, London boroughs like Merton (clocking 13.7 per cent) and Wandsworth (11.4 per cent). Such eyewatering increases are not confined to London and the South-East either: in Rutland, in the East Midlands, it was 11.6 per cent, and in Warwick it was 11 per cent.[27]

The second point is that rent inflation in the private sector certainly has outstripped *wage* growth as well as the cost of housing in other tenures, meaning private renters are becoming relatively less well off than those in owner-occupation or social housing. The housing charity Shelter has illustrated in detail the extent to which this is the case. In England between 2010/11 and 2011/12, for example, rents rose by 2.8 per cent on average compared with wage inflation of 0 per cent. In London, rents rose 4.8 per cent while wages dropped by 4.9 per cent.[28] A recent report by the Joseph Rowntree Foundation forecast private rents to rise by about 90 per cent in real terms between 2008 and 2040. [29]

Spiralling rents have a self-reinforcing impact on the evolution of the housing market as increasing numbers of people get caught in a 'rent trap' with nothing left to save towards a deposit on a home of their own. In a survey, Shelter found that nearly a third of renters had 'nothing left over each month after paying for essentials'.[30] This means that people remain reliant on private renting, maintaining demand and keeping prices high in a sector which does little to add to the growth of the housing stock (as we will explore in greater detail below).

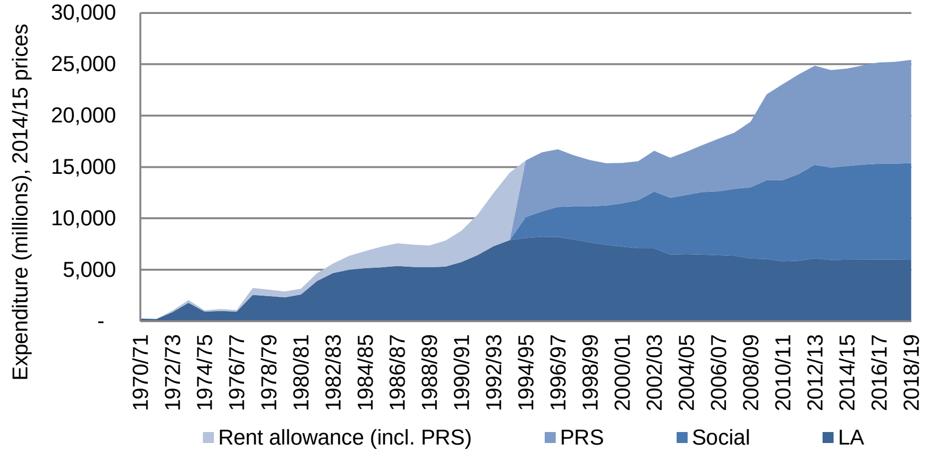
The housing benefit bill is spiralling

This widening affordability gap is illustrated well by the growing number of people who are coming to rely on housing benefit. In 1988/89, at about the time that rent controls were abolished and council house building went into terminal decline, the housing benefit bill was, in today's prices, £7.4 billion.[31] Since then, however, the cost has more than trebled in real terms and now comes to about £24 billion. The number of claimants has risen too, by about a quarter (from just under four million to just over five million in 2013/14).[32]

Despite attempts by the Coalition to keep the housing benefit bill down, it is forecast to keep growing in the years ahead. After a small fall in 2013/14 after the introduction of the Coalition's welfare reforms, the bill is expected by the government to hit £25.4 billion by 2018/19. Although housing benefit is used in local authority and social housing too, its growth has been most marked by its extension to, and increase in, the private rented sector since the early 1990s, as can be seen in Figure 1.[33]

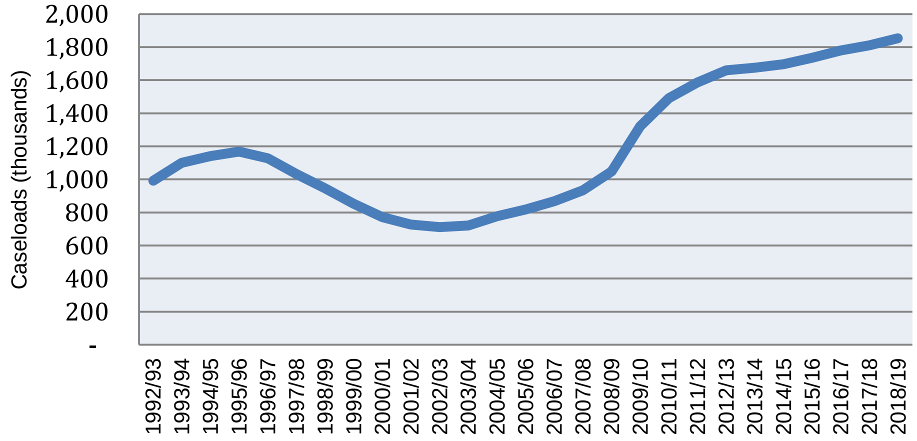
The number of private renters claiming housing benefit in England, Scotland and Wales has more than doubled since 2005/6, when there were 817,000, to 1.67 million in 2013/14. That figure is expected to grow further to 1.85 million by 2018/19 (Figure 2).[34] To put that into perspective, 25 per cent of private sector tenants now rely on housing benefit.[35]

Figure 2: Real terms housing benefit spending by tenure, 1970-2019 (including forecasts for future years). Source: DWP



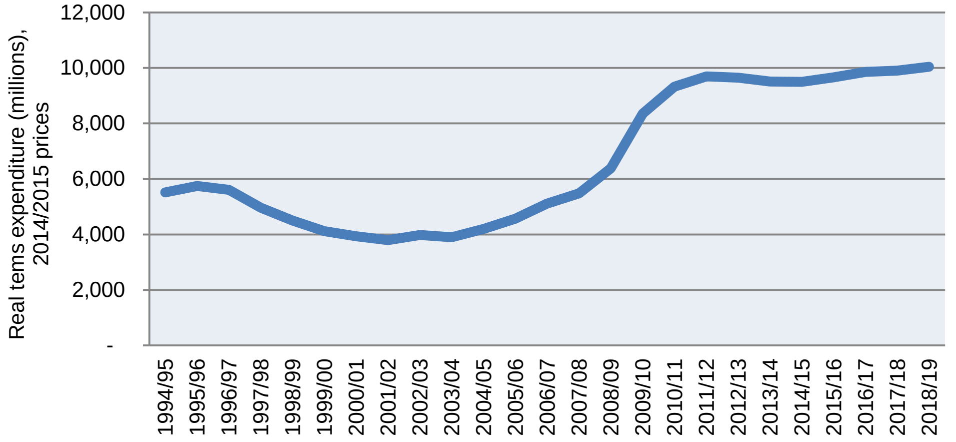
The amounts claimed in housing benefit by private sector tenants have risen in real terms from £3.9 billion in 2003/4 to an estimated £9.5 billion in 2013/14. They are forecast to rise further to just over £10 billion in 2018/19 (Figure 3).[36]

Figure 3: Housing benefit claimants in the private rented sector, 1992-2019 (including forecasts for future years). Source: DWP



Both the number of private sector claimants and how much they were claiming (Figure 4) was falling between the early 1990s and the early 2000s, coinciding with the height of owner-occupation and before the boom in buy-to-let. There were subsequently steep increases in each, and each is forecast to keep rising into the foreseeable future.

Figure 4: Real terms housing benefit spending in the private rented sector, 1994-2019 (including forecasts for future years). Source: DWP

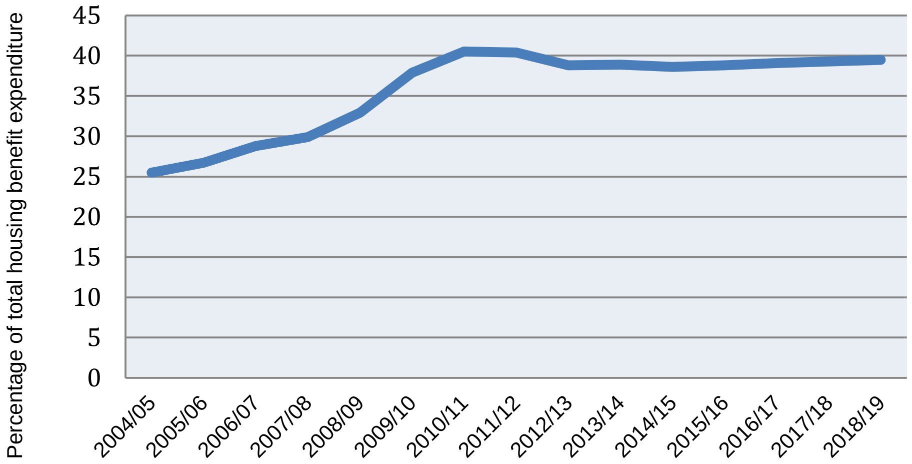


It is important to note that the rise in the housing benefit bill is not just about more people coming to rely on private rented accommodation; real terms rises in private sector rent are a major factor too. The Department for Work and Pensions has estimated that £2.9 billion (33 per cent) of private sector housing benefit expenditure in 2010/11 was the result of above-inflation rent rises over the previous decade.[37]

As a proportion of total housing benefit spending, the amount claimed towards private sector rents has increased by more than a half from 25.5 per cent in 2004/5 (£3.4bn out of £13.2bn) to 40.5 per cent in 2010/11 (£8.6bn out of £21.4bn). It fell as a proportion of total housing benefit expenditure in 2012/13 but according to forecasts will continue to rise again, albeit at a more moderate rate, for the coming years (Figure 5).[38]

This spiralling housing benefit bill is a major drain on the public finances and diverts public expenditure that could otherwise be used to build more homes that are badly needed to tackle the root of the problem. The imperative behind tackling housing benefit is not just about reducing welfare dependency, important as that is, but also ensuring that the public money spent on housing is invested usefully and supports wider objectives, including the building of more homes in the social sector. Labour leader Ed Miliband has identified the need to reduce the housing benefit bill in order to divert that money into building: 'We can't afford to pay billions on ever-rising rents, when we should be building homes to bring down the bill.'[39]

Figure 5: Private rented sector as a proportion of housing benefit expenditure (including forecasts for future years). Source: DWP



The government's budget for new affordable homes in England was just £4.5 billion for the period 2011-15,[40] a fraction of the housing benefit bill. Even taking the more generous benchmark of total housing development expenditure for the UK (incorporating non-building initiatives), the figure is only £6.5 billion.[41] This has been the result of a deliberate policy over several decades of shifting subsidies from bricks to benefits – from building homes to subsidising rents. This has itself contributed to the affordability crisis by reducing the rate of new constructions and effectively underwriting rents at the lower end of the private rented sector.

Growing numbers have no long-term security of tenure

Apart from the cost of renting, to both tenants and the taxpayer, another issue that is coming to the fore as the private rented sector demographic shifts is the lack of security generally on offer, as most tenancies are usually protected for just six or twelve months. Longer-term tenancies were effectively brought to an end with the introduction of assured shorthold tenancies to make the private rented sector more attractive to investors. Assured shorthold tenancies, guaranteeing landlords vacant possession after a limited time, were also important to the growth of buy-to-let because of the demands of mortgage lenders wanting guaranteed vacant possession.

For many younger people, who have traditionally seen renting as a short-term arrangement before settling down and buying a place of their own, this was not such a problem. The flexibility it offered was part of the attractiveness to the tenant, too. But as house prices have risen and younger people are taking longer to save up a deposit or are shut out of the market indefinitely, increasing numbers of tenants are entering middle age and have children. Surveys suggest that the average age at which people get on the property ladder is now late thirties.[42] The English Housing Survey 2012/13 found that almost a third of private renters had children - 20 per cent were couples with children, up from 12 per cent in 2008/9, and 12 per cent lone parents with children. The number of children living in private rented accommodation increased by more than a million in the decade before the 2011 census.[43] As the average private renter gets older, becomes more likely to have children and is less likely to be able to move on into owner-occupation at any stage, demand is growing for more stability in the tenure. A Savills/YouGov survey found that the majority of private renters above the age of 35 (and more than 30 per cent of those aged 25-34) would like longer tenancies.[44]

This is partly down to landlords but also partly down to their mortgage lenders, who set the conditions on their borrowing. Most lenders limit tenancy agreements to just 12 months. There have been some moves towards allowing longer tenancies but they remain tentative, with Nationwide and specialist landlord lender Paragon Mortgages offering 36 months and HSBC two years.[45] Three years is better than six months, but it is not what most people would call ‘long term’.

Landlords have contributed to house price inflation

High housing costs are not confined to the private rented sector, of course, even if they do cost private tenants a greater proportion of their incomes than those in other tenures. A long-term shortfall in the number of new constructions has led to a severe mismatch of supply and demand which has inflated prices across the board. But the growth of the private rented sector has exacerbated this problem as small investors have joined the scramble for property over the past two decades.

Despite the claims of some landlords, the private rented sector has not supported the building of new homes.[46] In fact, new-build homes are purchased mainly by owner-occupiers. Private landlords tend to buy existing homes, meaning their investments merely change the tenure profile of what is already there.

There are no precise official figures but the most generous official estimate I can find, in a Treasury consultation paper in 2010, suggested only one in ten of the buy-to-let loans taken out between 2004 and 2007 were on a new-build property.[47] The Private Landlords Survey of the same year suggested similar figures, with only four per cent of privately rented properties having been 'built specifically for the buy-to-let market', although another five per cent were purchased directly from developers brand new.[48] So, again, about 90 per cent of private rented accommodation was existing homes.

But it would appear that this picture in 2010 may have marked a high-point in private landlord investment in new-build. When the Treasury reported on the findings of its consultation later that year, respondents had seemed to cast serious doubt on the long-term commitment of landlords to even this level of new-build investment:

> '…a number of respondents believed that the apparent preference for new-build was a temporary phenomenon, and unrepresentative of the behaviour of the majority of professional individual landlords. It was suggested that this activity in new-build was driven by a large number of inexperienced new-entrants to the PRS market whose investment was primarily speculative, and who have been among those worst affected by the housing market downturn. This seems to be supported by the experience of those lenders who remained focused on professional landlords. Their clients continued to invest primarily in the existing stock.'[49]

The government concluded that it was 'unlikely that individual investors will favour new-build properties', and in its 2011 housing strategy there was no repeat of the suggestion that the private rented sector's expansion would increase overall housing supply.[50]

Even the British Property Foundation, which is opposed to rent regulation and points out the 'phenomenal investment' in housing by small landlords, says they have 'not made such a powerful contribution to new build stock'.[51] Research from the Building and Social Housing Foundation concludes: 'Whilst some buy-to-let activity may indirectly support housing supply (by acting as one end of a chain where this is a new-build home at the other end) the growth of the tenure has tended to largely represent a movement of existing stock between the tenures. Consequently, although the existing private rented sector provides a source of accommodation for rent, it typically does little to increase housing supply, to meet overall need and demand.'[52]

Yet despite doing little to meet overall need, private landlords clearly contribute a very significant proportion of the demand for sales. House price growth has been mentioned as an incentive behind landlords' investment in private rented accommodation, but given the staggering sums invested by them it might be asked how much of that price growth was in fact driven by landlords in the first place. To put things in perspective, buy-to-let accounted for 13 per cent of the total outstanding mortgages in the UK in early 2013, according to the Council of Mortgage Lenders.[53] Oxford Economics argued some years ago that the increase in buy-to-let and second homes was 'undoubtedly contributing to the overvaluation of housing'.[54] A study of this effect by the National Housing and Planning Advice Unit found that gross buy-to-let lending may have increased the average UK house price by up to seven per cent by the end of 2007.[55] But this is just part of the picture because only about a third to a half of privately rented properties have a mortgage at all.[56] Besides, the size of the private rented sector has increased substantially since 2007 (see Figure 6). By next spring it is expected that private landlords will own £1 trillion worth of homes in Britain.[57]

Institutional investment

The government appears to have shifted its emphasis in recent years and is now seeking major institutional investment – as opposed to small landlord investment – which is more likely to support the construction of new developments. Institutional investors are also less motivated by short-term capital gains and more interested in receiving reasonable long-term returns.[58] The Coalition set up the Montague review into the barriers to institutional investment in the private rented sector (which took as its starting point that 'growth in the rented sector has generally not contributed to the supply of new housing') and has introduced the Build to Rent fund to support 'developers more traditionally used to building homes for sale who are looking to branch out into building homes for private rent'.[59]

Sir Michael Lyons argues in his wide-ranging review of housing for the Labour Party that there is 'considerable potential for the market rented sector to have a positive impact on the housing market by providing additional homes', but he also sees the answer in institutional investment. 'The potential for growth in the number of homes for private rent is significant if institutional investment can be corralled… it is a model of investment that is much more prevalent in other countries.'[60] He points out, however, that the current dominance of short-term tenancies is one of the perceived barriers to attracting this institutional investment into the private rented sector: '…the short-termism of mainstream tenancy models has created a culture of churn and instability for renters, which undermines steady income streams for landlords and investors'. Longer tenancies and clearer rent structures may in fact attract the kind of institutional investment which could be key to the private rented sector fuelling house-building.[61]

Research by the Resolution Foundation has noted that institutional investment in Europe has been supported by the availability of 'long-term leases with transparent rent rises that reduce tenant turnover, lower the costs of empty properties and increase the predictability of returns for investors'.[62] The returns for landlords may even be improved by longer tenancies and rents indexed to RPI, a Jones Lang LaSalle report for Shelter found.[63]

In a report for Camden council, Kath Scanlon and Christine Whitehead of the LSE noted that 'institutional investors are looking for "utility"-type, long-term investments – i.e. ones with near-certain, index-linked, low-risk returns (which implicitly must remove the risks of unexpected inflation or additional costs) that match their liabilities. This is why some representatives of the finance industry have said that in principle rent stabilisation could be a positive inducement to investment'.[64] However, it is also stressed that a mandatory system may alarm institutional investors, who value stability (including in regulatory models) and steady rates of return above all, and 'hate uncertainty'.[65] As a result, Scanlon and Whitehead recommended for Camden that the authority act as an enabler of longer-term tenancies, with index-linked rent increases, *voluntarily agreed* between landlord and tenant.[66]

By and large, the expansion of the private rented sector has so far failed to increase the supply of new homes. It has helped to create the demand (at least in private sales if not for additional roofs) it is purported to meet. This warrants closer attention than it currently receives in the political debate about housing trends and the growth of the private rented sector. But efforts to shift private rented sector investment in the direction of new building projects should be encouraged, and a culture of longer-term tenancies may well assist in that ambition.

Chapter 3: The 'vicious circle' of housing benefit

Housing benefit is critically important to the millions of low-income households that claim it. Without it, many would not be able to afford to live, being unable to obtain one of the dwindling number of homes in the social sector, buy a property at prices that have grown out of all proportion to incomes, or afford the rent in the private rented sector on which they must increasingly fall. But housing benefit is not the only way of providing a safety net for lower-income households and there is evidence that it serves to exacerbate the very problem of affordability that it is there to alleviate. The more people come to rely on housing benefit, the more of a negative impact on price levels it is likely to have.

Its introduction and evolution

A form of housing benefit was first introduced in the 1970s, principally to support people in social rather than private renting. Its use was extended in the early 1980s, marking the beginning of a shift, not only in the UK but in several advanced nations including France and the US, away from subsidies supporting building and towards subsidies supporting people's ability to pay.[67] But it was not until after the abolition of rent controls with the Housing Act of 1988 that the benefit became the principal tool by which those on lower-incomes were supported in their housing needs. By then, a fall in construction levels was already beginning to translate into higher housing costs, social housing was being sold off into owner-occupation and with the deregulation of the private rented sector there were widespread concerns about the affordability of housing.

It was well anticipated when rent controls were scrapped in the 1980s that rents would go up – that was of course the intention, as part of an ambition to rekindle the private rented sector after decades of decline.[68] To those who warned that increasing numbers of people would be then unable to afford those market rents, the response of the government was to say that housing benefit would cover any difference between what people could afford and the market rent. As the then environment secretary Nicholas Ridley told MPs: 'Housing benefit will be available for all those whose incomes are low enough to qualify for full or partial benefit, irrespective of the rent charged.'[69]

Having lifted the ceiling on rents, the government would instead ensure that tenants had the means to pay whatever landlords would then ask for in rent. Until 2008, and the introduction of Local Housing Allowance (LHA), housing benefit was based on covering the whole of a claimant's rent, minus deductions according to income and family circumstances. But the scope for abuse, and the suspicion that such a system would not just provide a safety net for the less well-off but actually inflate prices, was never far from the surface. Ridley himself referred to the possibility of 'conniving to milk the Exchequer by charging an unreasonably high rent for the property in question… taxpayers' money ought not to be used to allow landlords to inflate rents to excessive levels'.

In an attempt to prevent landlords charging over the odds, the amount payable in housing benefit was subject to limits – the Local Reference Rent, set by independent rent officers – which had regard to local prices and the size of the household.[70] This was meant to ensure that housing benefit neither fuelled rent increases nor enabled people to live in more expensive private sector accommodation than they otherwise would. However, the danger was not just in deliberate 'conniving' by a few unscrupulous landlords but in this growing public subsidy being priced into the rent expectations of landlords. Once tenants' housing expenditure was guaranteed not to fall below a certain amount, rents would never fall beneath that figure and the market rate would be held up. The logic of this was spelt out when Sir George Young, the then housing minister, told the Commons a few years later: 'Housing benefit will underpin market rents… If people cannot afford to pay that market rent, housing benefit will take the strain.'[71]

If rents became unaffordable, not landlords but the general taxpayer would 'take the strain'. Prices were 'underpinned'. Housing benefit introduced a system of rent floors, at the lower end of the market, beneath which landlords need never reduce their prices. The result of this has been to push up rents, at least for those claiming housing benefit – a growing proportion of households – and possibly for the wider market too.

General inflationary effect

Housing benefit is a demand subsidy, allowing consumers to spend more than they otherwise would be able to afford. Previously, governments had focused housing expenditure into supply subsidies, which increased the stock of housing, mainly (but not exclusively) via local authority building schemes which alleviated price pressures. Given that the effect of housing benefit is to increase spending power in private renting, it is to be expected that – all other things being equal – the rents on the kind of properties on which it is claimed will be higher than if there were no such subsidies. This is precisely what a series of empirical studies of housing benefit, in the UK, France and the US, have discovered to be the case. This is due to the inelasticity of supply: the provision of new privately rented homes is not responsive enough to the increase in demand from subsidies.[72]

One such study was into the use of rent vouchers in the private rented market in the US. This found that costs for non-subsidised households had risen as a result. In the 90 biggest metropolitan areas, vouchers had raised rents by 16 per cent, on average, and in areas where the use of vouchers was more prevalent, the impact on rents was greatest. The overall impact of the vouchers was to cause an $8.2 billion increase in rents, while the subsidy provided by the vouchers was only $5.8 billion – a net loss of $2.4 billion to low-income households.[73] In France, a very similar effect has been observed in the use of housing benefit there. Every additional euro of housing benefit expenditure led to an increase in rents of 78 cents, so the benefit to tenants was only 22 per cent of the cost; the rest was to landlords.[74] In England, the housing benefit system was studied for the Centre for Economic Performance in 2003, based on reforms designed to reduce expenditure in the 1990s. This found that 'some of the incidence is on landlords', meaning that landlords benefited from the subsidy in higher rents, although different datasets gave different results on the extent of this. One showed landlords absorbing all of the reduction in the subsidy via lower rents, while the other showed tenants absorbing 10 per cent-15 per cent of the reduction.[75]

Most recently, the Institute for Fiscal Studies has analysed the impact of housing benefit in terms of the effects of the Coalition government's reforms to reduce Local Housing Allowance expenditure. Citing those studies mentioned above, it observed that 'empirical studies of the impact of rent subsidies have tended to find that the incidence is largely on landlords – in other words, rent subsidies result in higher rents – mainly because the supply of rental accommodation is unresponsive to changes in rent levels. This is true both in the UK and elsewhere.' It pointed out that varying systems and markets – whether overseas or at different times in the UK – would have varying experiences in terms of the impact of housing benefit.[76]

In its analysis of only the first 11 months of the Coalition's reforms, it found that claimants' rents had fallen to the value of 11 per cent of the reduction in maximum entitlements. This average included large variations, however, including 'relatively substantial, and statistically significant, reductions in rental values in the suburbs of London and in the East Midlands'. In both of those areas the majority of the incidence fell on landlords rather than tenants. In the London suburbs, it was 66 per cent on landlords and in the East Midlands 58 per cent. For London as a whole it was 26 per cent. However, the IFS found ‘no clear pattern’ between how LHA impacted rents according to the density of claimants in different local markets, which might be due to the segmentation of the LHA and non-LHA housing markets.[77]

This inflationary effect might not be such a problem for those households receiving housing benefit to cover their rent in full, but it is an issue for those households who only have part of their rent covered, and must make up the difference themselves, and it is also important to the general taxpayer who is covering the costs.

Lack of incentive for tenants to negotiate on price

Apart from the general inflationary effect of a demand subsidy like housing benefit, there are specific ways in which it influences behaviour to contribute towards this. One of the problems that has long been identified is that it disincentivises claimants from negotiating with landlords, or seeking out the best price, in a way that they might do if they were spending their own money. This was spelt out in a report by John Hills for the Department for Communities and Local Government under the last Labour government:

> ‘…for someone receiving it, if rent is £1 per week higher, benefit is £1 per week higher. This can be criticised as removing any trade-off between people’s net housing costs and the actual rent of the property they occupy: on the one hand this might create incentives to occupy more expensive accommodation than otherwise; on the other it means that someone who does economise gains no benefit for doing so.’[78]

The Local Housing Allowance system, rolled out nationally in 2008, was supposed to move away from this. Benefits were no longer based on actual rents but on the median levels of rent within localities. Under this new flat rate regime, tenants would also be able to shop around and keep the difference if they secured a cheaper rent than their LHA covered.[79] It was hoped that this would exert a downward pressure on rents as tenants would resist rises because that would directly affect their financial situation. After a series of pilots, which provided evidence of more negotiation over the rent between tenants and landlords,[80] this was rolled out nationally in 2008 – although the difference that a tenant could pocket was limited to £15.[81]

However, this incentive for tenants was short-lived, being subsequently scrapped by the Coalition government from April 2011 (although the previous Labour administration had initially proposed its abolition without implementing the move). The Coalition said that although it provided a 'limited incentive' to shop around, the government's priority was in reducing housing benefit expenditure and that 'other measures being taken to reduce rates overall will reduce any impact the removal of the excess may otherwise have in increasing rates'.[82]

Artificial market rents

Another significant problem is that the way LHA is calculated is not subtle enough to deal with variations in market prices within an area. Awards are made according to the average costs of renting in whichever 'broad rental market area' (BRMA) a claimant belongs to. But these BRMAs often contain such a range of different sub-markets that the LHA rate is too high in some areas and too low in others.

As the IPPR think tank puts it: 'Landlords in some areas are able to overcharge the taxpayer, while completely pricing out housing benefit recipients elsewhere.'[83] In Sheffield, the city council believes there are about 1,500 homes where the LHA is too high and where £300,000 a year could be saved if it was brought down into line with the actual market rent.[84]

In addition to the difficulties posed by local sub-markets, the more people there are who claim LHA in any given area, the more difficult it becomes to discern what would be the market price without it. In Blackpool, for example, about 80 per cent of the 17,000 privately renting households receive housing benefit. Not only does this mean that market rent calculations have to be based on a very small proportion of the market, but those that are not in receipt of housing benefit tend to be of a higher standard, commanding a higher rental value. Blackpool's BRMA also takes in outlying suburban and coastal areas that have fewer benefit claimants and higher property values. As a result, Blackpool council says, the LHA rate for the town tends to be higher than the quality of accommodation on offer 'because it is based on the few best properties that aren't let to benefits claimants, and market rents in better areas'.[85]

Landlords have spotted the potential. They can – and do – charge rents at the artificially high LHA rate even though that is more than the market value of their property. It should come as little surprise then that Blackpool's private rented sector has grown quickly in recent years. The council says:

> 'Landlords letting to people on Housing Benefit tend to set their rents at the LHA rate. This means that it is very profitable for landlords to buy and let out accommodation to

> benefits claimants in Blackpool, demonstrated by the doubling in HB claimants in the private rented sector seen in the last 10 years, from around 7,000 ten years ago to 14,000 now. This trend continues, with most property sales in the inner parts of Blackpool to investors rather than to owner occupiers. The artificially high levels of LHA mean that it is far more financially advantageous for property owners to rent to Housing Benefit claimants than to improve their homes to enable sales to owner occupiers.'[86]

In 2013, the cross-party Communities and Local Government Committee condemned this as a 'vicious circle', saying: 'It is perverse that large sums of public money are being spent in a way that serves only to drive up rents and damage the fabric of the town.'[87]

The vicious circle on display in Blackpool illustrates well the price- and market-distorting qualities of housing benefit which prevent rents finding their natural equilibrium. There are plenty of other places too with very high numbers of housing benefit claimants in the private rented sector. Research by Shelter highlights 56 local authorities where more than half of privately renting households were in receipt of LHA in 2010. To cite some of the most extreme examples: Knowsley (89 per cent), St Helens (73 per cent), Corby (82 per cent), Castle Point (87 per cent), Tendring (71 per cent), Barking and Dagenham (85 per cent), Enfield (75 per cent).[88]

The IPPR proposes a system of more responsive local rental market areas in which LHA would be set by the local authority rather than being centrally-agreed, unresponsive and giving rise to distortions. This would be an improvement. There is also an argument that where landlords are as dependent on housing benefit subsidies as they are in places like Blackpool, the council should be given the ability to use the bargaining power that arises in such a situation and strike a better deal, negotiating with landlords to keep rents down. This too is a good idea to iron out some of the local inconsistencies.

But while such measures might help to limit the future impact of housing benefit on rents, the soon-to-be £10 billion subsidy is still in the system. We are left in a position where housing benefit 'keeps rents high by actually paying those high rents'.[89]

Reforms have failed to address the fundamental problem

As has been noted in passing, there have been several attempts to reform housing benefit to try to keep costs down and iron out anomalies. The Coalition, mindful of the ballooning costs of housing benefit, has also sought to tackle the issue in recent years. Its reforms have included moving the LHA rate down from the median rent in a given area to the thirtieth percentile and placing national caps on categories of properties.[90] A further change has been to cap the uprating of LHA levels at one per cent a year[91] - previously they were reviewed monthly against movements in private sector rent levels. This should, in theory, keep any increase in LHA below increases in rent levels, therefore placing a downward pressure on rents, although there are exemptions for areas with the highest rent increases. However, this will not stop more people becoming reliant on housing benefit as rents rise; it does not deal with the distortions within BRMAs such as in Sheffield and Blackpool; and it does not deal with the effect on rents that the existing £9-10 billion subsidy already has.

It remains early days in terms of the impact of the Coalition's reforms, but the initial evidence is that they will not fundamentally change the trajectory of the housing benefit bill, which, as we have seen, is still rising and projected to continue on that path until at least the end of the decade. There is also evidence that while reductions in LHA have resulted in lower rents, much of the impact of cuts has been passed on to tenants.[92] Ultimately, rents are expected to continue rising, more people will come to rely on housing benefit, the bill to the taxpayer will keep growing and the 'vicious circle' will continue. [93]

Having come to rely so extensively on housing benefit as a safety net, it is impossible now to remove it without creating enormous disruption and social upheaval. Frank Field, the former welfare reform minister who witnessed the introduction of housing benefit as an MP, described several years ago how concerns about the impact it would have were dismissed until it was too late to do much about it.

'At first, few people spoke against a scheme which ostensibly helped the poor to pay their rent. Warnings that housing benefit would push up rents to a level which increasingly working people would not be able to afford, and that fraud would be endemic in the system, were dismissed as irrelevancies,' he wrote. Later, by the time its flaws began to be taken seriously, 'a diet of escalating rents, rising corruption and housing benefit bills out of control, left the government with little idea how to control the monster it had created.'[94] This remains the case today and means we need to find another way of holding down costs.

Chapter 4: Rent regulation, past and present

Rent regulation has been increasingly on the agenda of late, as housing costs have continued to grow and incomes have been squeezed in the wake of the recession. The UK has already experienced rent regulation, when controls were in place between 1915 and 1989. During the same period there was a monumental decline in the size of the private rented sector, as we saw in Chapter 1. Since the abolition of rent controls and the introduction of the assured shorthold tenancy, the private rented sector has bounced back. This trend is frequently cited as evidence that rent controls led to the collapse of the private rented sector; and their removal has allowed it to flourish again.[95] It is difficult to deny that holding prices lower than landlords would otherwise charge would make the sector less enticing, relatively, for investors. Similarly, it is easy to see how removing such controls and giving landlords the right to take back possession of their property made it more attractive to potential investors. But these changes to tenure law did not take place in a vacuum and there is a danger in this argument of ignoring other important factors which have also had a significant impact on the evolution of the sector over the past century.

British rent control 1915-1989

Rent controls in the UK took a variety of forms, ranging from a straightforward freeze during and after the First and Second World Wars to the ‘fair rents’ regime of the 1960s (and still extant, for a dwindling number of households, today) which sought to remove the effect of scarcity in the rental market.

The first move was the Increase of Rent and Mortgage Interest (War Restrictions) Act 1915, which limited rents on unfurnished ‘working class’ homes – and their landlords’ mortgage interest rates – to levels at the outbreak of war in August 1914. It was amended soon after to restrict landlords’ ability to take back the property and put it to a different use. Intended as a temporary measure, designed to expire six months after the end of the war, it was extended further in subsequent years, to virtually all properties by 1920, in response to the housing shortage which followed the First World War. However, rents were allowed to rise by a certain proportion of their 1914 levels and controls did not apply to new dwellings. The legislation was popular with both tenants and landlords (whose mortgage interest was kept below market rates) and, when the Conservative government wanted to phase out controls in the 1920s, they felt unable to overcome public opposition to the move.[96]

Having been relaxed during the 1920s and 1930s, rent controls were reinstated in full after the outbreak of the Second World War with the Rent and Mortgage Interest Restriction Act 1939, which froze rents at that year's levels. This Act also remained in place long after it had originally been intended to expire, and with the post-war housing shortage pushing up house prices and earnings rising, controlled rents fell in real terms. Unlike the previous regime, new properties were not to be exempt from controls until the 1954 House Repairs and Rents Act, which also allowed limited increases in rents for properties that had been kept in good condition. The 1957 Rent Act removed controls from more valuable properties and, significantly, those had vacant possession – a measure which led to 'Rachmanism' as unscrupulous landlords sought to force out tenants so that they could secure vacant possession.[97]

Labour reintroduced security of tenure and 'fair rents' with the 1965 Rent Act. This introduced a rent system that was meant to allow for market rates to be agreed between landlords and tenants, either of whom would have recourse to a rent officer to adjudicate if they did not feel it was a fair rent. Regulation on new private tenancies was abolished with the Housing Act 1988, but a small number of regulated tenancies from the previous regime remain where tenants have not moved home since the 1980s.[98] These 'regulated tenants' still have fair rents on their properties determined by independent Valuation Office Agency rent officers. In determining a fair rent, officers are required to calculate what the rent would be if there were no scarcity in the provision of similar homes. This has led to a series of legal disputes since the 1990s when, for the first time, 'fair rents' could be compared with examples of market rents in the same vicinity or even in the same block.[99]

The decline of the private rented sector

While rent controls were undoubtedly a factor in the decline of the private rented sector, they were only one part of a political climate that sought to give owner-occupation and, for a time at least, local authority accommodation the upper hand. Conditions designed to allow owner-occupation in particular to grow were at the same time damaging to private landlords. These initiatives played an important part in raising living standards and spreading wealth to a growing middle class throughout the twentieth century.

Before the First World War, and the advent of rent controls, owner-occupation stood at about 10 per cent,[100] with almost everybody else renting from private landlords. In 1918, municipal housing accounted for just one per cent of the housing stock.[101] Home ownership was for the privileged few and local authority housing barely existed. These proportions first began to change as a large number of new homes were built by local authorities, starting with the Housing and Town Planning Act of 1919, which for the first time required councils to provide accommodation and provided them with state subsidies for doing so. By 1939, there were almost a million homes in the social rented sector. In the decades after the Second World War, millions more homes were built by councils under successive state programmes, so that by 1981 there were 5.5 million households renting from local authorities or other social housing providers, 31.7 per cent of all homes in England and Wales. These council homes provided most of the increase in the housing stock, which grew from 11 million in 1939 to 17.2 million in 1981.[102] Building for owner-occupation, also supported by successive governments, contributed a large number of new homes too, some 2.6 million between 1960 and 1975 alone.[103] This emphasis was quite different to that in other European countries (notably Germany, which we will consider later) where building for private renting was heavily subsidised and incentivised by governments.

So the building of millions of new homes in other tenures played a significant role in the decline of the private rented sector *as a percentage* of the housing stock. But the private rented sector also declined in absolute terms, from roughly seven million homes before the First World War[104] to 1.7 million in 1988, a loss of more than five million private rentals.[105] Most of these were absorbed into the growing owner-occupied sector. It is estimated that about three million privately rented homes were sold into owner-occupation between 1938 and 1975.[106] Roughly a quarter of those were purchases by sitting tenants.[107] The other principal way in which private rented stock was lost was by demolition in a series of slum clearance programmes. Figures are hard to come by, but one estimate puts the number of private rentals demolished in slum clearance at 1.6 million between 1938 and 1975.[108]

Of the circa seven million privately rented properties on the eve of the First World War, about a quarter (net) remained in the sector in the 1980s, about a quarter were demolished in slum clearance and about half were sold into owner-occupation. The question that arises is *why* did so many landlords sell their properties to owner-occupiers? And why did the private rented sector not expand with the increase in constructions for private sale? Clearly, rent regulation reduced the scope for profit on their investment. But it should be noted that rent controls did not apply to new properties in the inter-war years, when the private rented sector started going into decline. Nor did it experience a revival after the 1954 Act exempted new properties once more from controls.[109]

A variety of other factors were influential in the decline of private renting, mostly designed by politicians to promote owner-occupation, with the idea of a 'property-owning democracy' entering the Conservative lexicon in the 1920s.[110] By then Neville Chamberlain, responsible for housing at that time as Minister for Health, felt the era of small landlord investment in housing had passed.[111] The objective of expanding home ownership became firmly established in British political discourse in the post-war era, with Labour governments too desirous of ensuring that it was spread to a wider pool of occupations.[112] Harold Wilson's government, in a 1965 White Paper, described the expansion of owner-occupation as a matter of 'long-term social advance'.[113] Thus public policy was designed to that end, even to the extent that building for private sale was directly subsidised by the government in the 1920s.[114] But subsidies mostly came in the form of tax incentives for homeowners like mortgage interest tax relief and the exemption of owner-occupied housing from capital gains tax. The result was 'a considerable tax-bias in favour of owner occupation'.[115]

Another major factor behind the divestment of properties by private landlords was the new-found ability of householders to buy their own homes. This was a result of a rise in real wages and much improved mortgage lending opportunities – also strongly supported by the government. In the 1920s and 1930s, disposable incomes rose (for those in work) while the cost of a new home fell, because high unemployment meant low labour costs. At the same time, mortgage lending became much easier to obtain, partly because local authorities were empowered to lend to homebuyers and building societies expanded, also backed by the government, with councils encouraged to guarantee their advances. The mortgages on offer came to cost less and the deposits required up front were reduced.[116] Consequently, the number of people buying with a mortgage grew rapidly from 554,000 in 1928 to 1.4 million in 1937.[117]

In these conditions, and because the demand for private renting was shrinking as people moved into home ownership, it became uneconomical for investors to put their money into private rented accommodation. This was reinforced by the new availability of higher yields on investments elsewhere, including in the cash-hungry building societies. The academic Stephen Merrett, who charted the history of housing tenures in 20th century Britain, noted of the inter-war period:

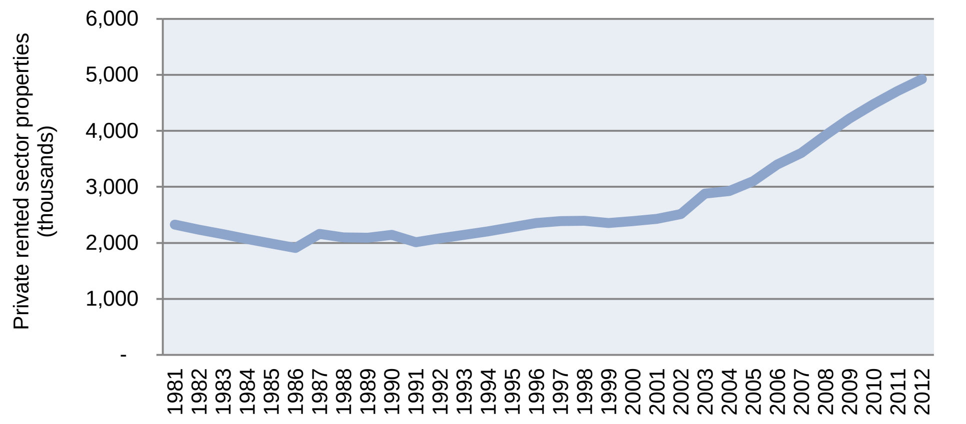
'…the development of the capital market, including the building societies, now offered rentiers a much greater range of placements which, in comparison with "widowers' houses", were less risky, more liquid, less lumpy and simpler to administer. In brief, if expenditure on rental accommodation were to undercut sufficiently the costs of owner-occupation to make it attractive to the tenant, it would no longer compete with the returns proffered by the money market to the landlord.'[118]

This analysis – that market rents in the private rented sector could not compete with the returns on offer to investors from elsewhere – suggests that private renting would have become unattractive to investors with or without rent controls.

1989-present: buy-to-let mortgages and house price inflation

That rent regulation was not the sole cause of the decline of the private rented sector is also borne out by the fact that its abolition did not immediately herald the beginning of a new era of private renting. While there was a modest rise in the number of homes in the private rented sector following deregulation in 1989, the boom that led to its rapid re-expansion did not occur until about a decade later (Figure 6). Most of the new generation of landlord investors came along after the introduction of buy-to-let mortgages in 1996 and as house prices began to spiral exponentially – in other words, when a variety of factors came to tilt conditions in favour of investment in private renting.

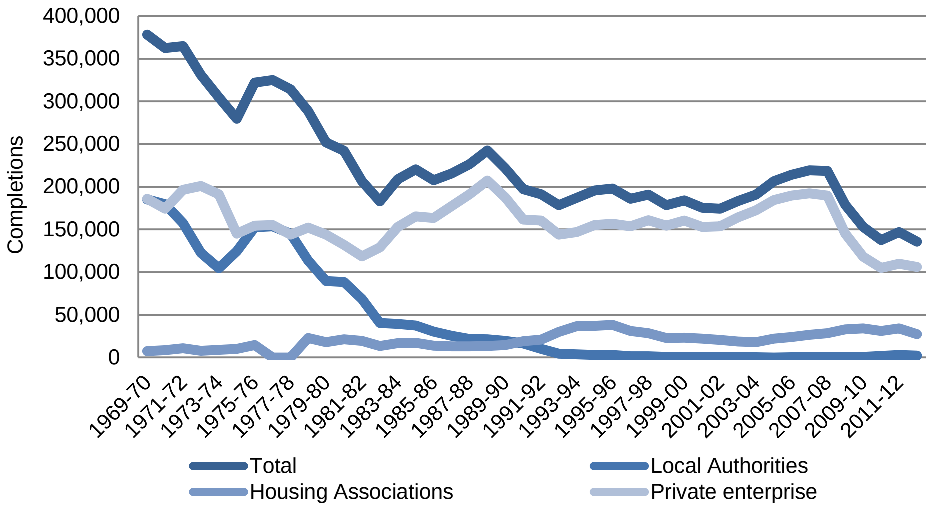
Figure 6: Number of privately rented homes, UK, 1981-2011.
Source: DCLG



Buy-to-let mortgages, introduced as shorthold tenancies became the norm, were designed to make it easier for small investors to become landlords. Paragon Mortgages, one of the UK's leading landlord finance providers, says that it was the introduction of buy-to-let, rather than the abolition of rent regulation, that kicked off the private rented sector: 'Regulated rents undermined returns and tenant legislation limited landlords' right to recover their property from a defaulting tenant. The 1988 Housing Act was the catalyst for change, boosting landlords' confidence in the sector by assuring their absolute right of possession. However, the introduction of buy-to-let mortgages in 1995 [sic] was the main driver of growth in the sector.'[119]

But another major factor which convinced many investors to pursue buy-to-let opportunities was rapid house price inflation, as the supply of homes failed to keep up with demand. This only became a factor in the late twentieth century, and particularly its final years.

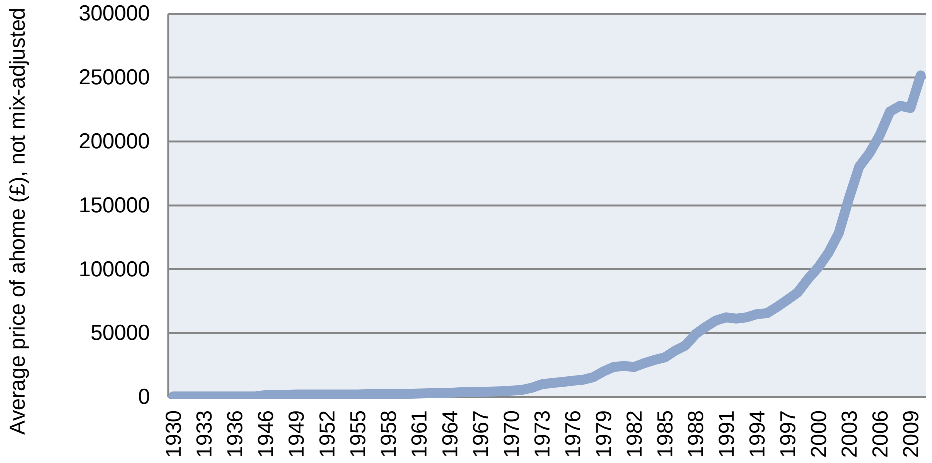
Figure 7: House building by tenure, 1969-2012. Source: DCLG



Throughout the post-war period, successive governments had competed with each other to build more homes and, by 1970, housing supply was in surplus (although there were localised shortages).[120] From the 1970s, when public spending pressures began to curb local authority building, new construction began to fall. It entered a serious decline in the 1980s when the then government effectively prevented councils building any more homes (although council house building was the principal loss, private enterprise completions failed to make up the difference, resulting in a net fall in volume – as Figure 7 shows).

Before this slump in house building, prices grew slowly, with none of the quick and easy capital gains that the housing market has come to be associated with over the past decade or so. Combined with a growth in the number of new households (or people *wanting* to form new households), this rapidly drove up house prices and property became one of the more attractive forms of investment available. As Figure 8 demonstrates, prices had begun to pick up from the 1970s, but most of the explosion took place after the mid-1990s – coinciding with the rise of the private rented sector.

Figure 8: Average house price, nominal terms, 1930-2010. Source: DCLG/ONS



But it was not just a coincidence. It has been widely acknowledged that this house price growth was, and remains, one of the principal attractions of the sector to small investors. That investors were drawn to the housing market by the capital gains on offer – and with buy-to-let finance giving them the opportunity to take advantage – was considered by the government's consultation on the private rented sector in 2010, which found:

> 'The incentives for individual investment in the PRS mentioned by respondents were the rapid increase in property prices and the ready availability of low-cost mortgage funding. There was a consensus that access to buy-to-let mortgage finance had been a significant factor supporting the substantial growth in PRS housing since 2000 and that mortgage availability would be the key issue facing individual investors in the PRS going forwards. Respondents indicated that uncertainty over property values could impact on individual investment in the PRS in the short-term. However, the medium-term expectation is that capital value growth will return, along with mortgage funding.'[121]

This again demonstrates that deregulation was only one factor in the renaissance of the private rented sector. It also has implications for future policy making and the consideration of rent regulation as it suggests that landlords are not as motivated by the rental yields on offer as might be assumed.

The Private Landlords Survey of 2010 provides further detail about the attitudes of investors, showing that only a third saw their buy-to-let properties as a source of rental income alone. The rest were just as attracted by the expectation of capital appreciation – in fact 24 per cent saw it in these terms alone.[122] The government's Montague review, in 2012, spelt out the 'capital *vs* income' ratio that private landlords have experienced: '…because of the strong values prevailing in the owner-occupied market, a high proportion of investors' returns on residential rented properties has tended to be delivered as capital growth rather than as rental income, with capital growth delivering an average of 5.9 per cent annually over the last 10 years compared to 3.5 per cent in income return (defined as net rent after management costs).'[123]

Whether one regards the shift in stock from the private rented sector to owner-occupation across the course of the twentieth century as a good or a bad thing, it is clear that rent controls were only one of the factors behind it. The affordability of housing, the availability of mortgage finance and the tax incentives in place at the time were all conducive towards a shift in tenure to owner-occupation over private renting. Today, the tables have been turned. Not only have rent controls and security of tenure been scrapped but mortgage interest tax relief was abolished in 2000[124] and prices have vastly outstripped wages. Conditions now promote the growth of the private rented sector and the decline of owner-occupation.

Rent regulation overseas

Rent regulation is not incompatible with a thriving private rented sector that is attractive to investors. Many nations in Europe, almost all with a larger proportion of private renters than England, also have a greater degree of regulation to this day. First-generation controls – the kind of freezes that were used in the UK during and after the First and Second World Wars – are rarely found today, and restrictions on initial rents are increasingly unusual too. But restrictions on in-tenancy rent rises are common, and in most countries security of tenure is indefinite.[125] However, there are obvious difficulties with simply transplanting one regime and grafting it on to the UK, as in all cases the stability and success of the sector is determined by a multiplicity of factors, which must also be taken into account.

In Germany, tenancies are usually indefinite and landlords are unable to remove tenants without good reason, such as breach of contract or arrears.[126] Security of tenure remains even when a property is sold or inherited, and landlords are prevented from selling up to realise capital gains.[127] Rents are freely negotiable at the outset (as long as they are no more than 20 per cent above the local average rate), but cannot be increased by more than 20 per cent in a three-year period and not above the average local rent, according to a local rent index.[128] The exception to this is where dwellings are modernised or undergo energy efficiency improvements, where the landlord can put 11 per cent of the costs onto the rent. Rents can still go up, but prices tend to be below the market level in areas of high demand.[129]

It is remarkable, from a UK perspective, that the private rented sector, with its indefinite tenancies and restrictions on rent rises, remains an attractive proposition for investors. About half of the housing stock in Germany is in the private rented sector, about 60 per cent of which is owned by small private landlords, who see it as a way to save for retirement.[130] Security of tenure is not seen as a bad thing but rather as 'an attractive way of keeping down voids and management costs, which in turn ensures the long-term secure returns', including for institutional investors.[131]

Satisfaction levels with private renting are significantly higher in Germany than in the UK, and it is not unusual for Germans to spend much longer in rented accommodation before buying a home, although the limited size of the owner-occupied portion of the market, and tough rules on mortgage lending, are also barriers to owner-occupation which curtail their choice in the matter. These are factors which ensure that many tenants also take a long-term perspective of private renting. There is also a greater tendency for tenants to furnish properties themselves and take more of the responsibility for improvements, right down even to installing kitchens, which also reinforces their long-term commitment to a property.[132]

That the private rented sector in Germany grew so large despite its relatively high degree of regulation is a phenomenon highly pertinent to current debate about rent controls. It has been the result of long-standing German housing policy, which – unlike in Britain, where financial support for new housing was targeted at local authority building and construction for owner-occupation – has always sought to encourage private landlord provision; this was the principal method by which the country's housing stock was rebuilt following the Second World War.[133] Rent regulation was accompanied, under the West German First Housing Law of 1950, by subsidies and fiscal incentives including interest-free loans for anybody wishing to invest in housing.[134] These included a depreciation allowance which could be used to offset tax bills. (A 'degressive' system was in place for a long time, providing large deductions in the early years; this was abolished in 2005 and replaced by a linear system.) There were bricks-and-mortar subsidies for private renting; these have also been wound down in recent years as an oversupply in housing has reduced the need for new homes.[135] There is also a capital gains exemption which, to avoid speculation and reinforce long-termism, only kicks in when the property has been owned for ten years.[136] Furthermore, any negative income from housing investments can be deducted from other income for tax purposes.[137]

The combined effect of subsidies and regulation has been to create a regime which is attractive to both tenants and landlords (as demonstrated by tenants' satisfaction and landlords' investment) without recourse to the large-scale state ownership of homes. In this context, rent regulation, far from being the enemy of the market, was seen as its safeguard, tempering price rises and averting property bubbles to ensure that it could be safely harnessed in the pursuit of social objectives:[138]

> 'The functioning of the German rental market is highly symbolic of the social market economy philosophy first established in West Germany and now which is enacted for the Federal Republic. This philosophy claims that social welfare is best served by bringing about economic progress through the invisible hand of the market, where government intervention is designed to support the proper and efficient operation of the market.'[139]

In practice as well as in theory, regulation of Germany's very large and well-functioning private rented sector is regarded as beneficial to tenants without harming landlords: 'Regulation of rent increases has kept rents relatively low… The general perception is that regulation in the German context is beneficial to tenants without penalising landlords and reducing investment in the sector.'[140]

There are lessons for Britain in the long-term nature of landlords' commitments in Germany's private rented sector, and how fiscal incentives can be used to underpin that and offset concerns about regulation. But where experiences in Germany and Britain differ sharply is in the supply and cost of homes. Germany has not had the housing shortage witnessed in the UK and so house prices have not driven behaviour in the same way. In fact, prices have been falling in Germany for the past two decades.[141] Landlords in Germany have not had the lure of capital gains that they have in Britain. This is a major difference which would have to be considered if something close to the German model of regulation were to be used in the UK.

Other countries with large rental markets

While again remembering that all markets are different, there are certain features which tend to recur in the regimes of countries with large private rented sectors. Most notably, the tax incentives for the private rented sector in Germany are common elsewhere. This seems to be the biggest determining factor, rather than the degree of rent regulation, behind the historic growth and present health of private rental markets. A 2010 report for the Department for Communities and Local Government (DCLG) observed: 'The large private rented sector countries all offer taxation advantages, especially to individual investors, which are more favourable than those available in England.'[142]

This often includes the ability of individual investors to use their losses from rental income to offset their tax bills. In Germany, France, the US and Switzerland – all with larger rental markets than the UK - a variety of grants, subsidies and low-interest loans have been used to encourage private landlord investment in homes which are regarded as social or otherwise subject to rent and allocation conditions.[143]

Unlike landlords in the US, Australia, France and Germany, those in the UK are not allowed to deduct for depreciation costs against their tax on rental income. Rental income losses can also be deducted from other taxable income in all of these countries, removing some of the pressure on landlords to increase rents. In encouraging long-term holdings in the private rented sector, all of these countries also discourage short-term investments in private renting through the capital gains regime, with deductions in the tax applicable when the property is sold after various periods of time.[144]

Another feature that is worth noting is that where rent regulation is used, landlords are sometimes allowed to increase rents above the official limit to take account of rising costs or improvements to the building. In Germany, as we have seen, 11 per cent of the costs of modernisation and energy efficiency measures may be added to the rent, even if that is above the usual limit. In Switzerland too, another country with a high proportion of private renters, rents are regulated but can be increased if the landlords' costs increase.[145]

There are also often different regimes applied to newly-built homes. Many countries have deregulated only new homes, so existing stock – including new leases – remain subject to restrictions. This is the case in the Netherlands, for example, where 75 per cent of homes still have controlled rents.[146]

What sets the UK apart from most nations is the extent of its housing shortage and the consequent cost pressures to which that gives rise. That, and with it the desire to attract institutional investors who may be more inclined to finance new stock, would have to be factored into any proposed regime.

Chapter 5: Proposals for reform

Labour's proposal

Ed Miliband announced in April 2014 that a Labour government would introduce three-year tenancies, which landlords would only be able to terminate if they wanted to sell, refurbish or change the use of the property, or if the tenant falls into arrears, is guilty of anti-social behaviour or breaches their tenancy agreement. Importantly, having agreed an initial rent with the tenant, it could be reviewed no more than once a year and would be subject to an upper ceiling, based on an as yet unspecified benchmark 'such as average market rents'.[147]

The subject of rent regulation divides opinion strongly, but even among those opposed to the idea there are two strands of thought on Labour's proposals. One is that holding down prices in any way will damage the rental sector and by implication the wider housing market – an argument this paper seeks to challenge. The other is that it will not hold down prices at all. That is, rent inflation will not change, it will simply be imposed at three-yearly intervals instead. Or as Kristian Niemietz of the Institute for Economic Affairs has put it: 'London rents would still be extortionate – the extortion would just become more predictable.'[148]

Three-year tenancies, as well as potentially displacing the worst rent rises for three years at a time, also fail to provide a long-term arrangement for a family that wants to settle down. Greater numbers of families are coming to rely on the private rented sector when they would prefer to be buying a property where they can make a home for the long term. If the private rented sector really is to become a viable and attractive alternative to owner-occupation, it should be able to provide the same long-term tenure. Three years is not enough.

Going further: security and affordability

The scale of the challenge in the housing market requires more ambitious solutions. As a start, we should consider the following reforms:

1. Introduce indefinite leases as the norm

Tenants should ordinarily be allowed to remain in the property (subject to observing the terms of the lease) for as long as they wish, enabling them to make a home of their rented accommodation. This would give them the security of tenure that is found in the owner-occupied sector from which many are increasingly shut out. The evidence from overseas is that indefinite tenancies are not antithetical to a well-functioning private rented sector, as long as investors – and mortgage lenders – recognise the need to take a long-term approach to their business. This, if the private rented sector is to become a tenure of choice rather than last resort, is an attitudinal shift that needs to be encouraged. Were mortgage lenders to prove resistant, then the government should explore alternative ways of financing landlord investors, possibly using those banks in part-public ownership.

2. Restrict in-tenancy rent increases to an index-linked ceiling

Once freely agreed between the tenant and the landlord, rents should not normally be allowed to rise above inflation. The measure used could be CPI, or possibly – given that much of the pain in recent years has resulted from falling real incomes – average wage growth. Tenants would be protected from unaffordable price rises; landlords would lose the ability they currently have to maximise their returns; but they would have the security of a steady income stream and less turnover in their tenants, minimising vacancy periods and other costs arising from 'churn'. The average private renter has lived in their property for 3.8 years; this would probably increase, as tenants would be incentivised to stay put rather than move and face a higher rent elsewhere.[149] In this way, such a reform would exert a new downward pressure on rental prices, which would also curb the growth of the housing benefit bill.

Landlords should not be deterred from making improvements to accommodation during tenancies, however, particularly if they are to be lengthy. So there should be scope for a real-terms increase in rent, within reason, where modernisation is undertaken, comparable with the 11 per cent figure used in Germany. Additional flexibility may be required where there is a significant additional cost borne by the landlord with, for example, a rapid rise in interest rates

3. Use a wider range of incentives for private landlord investors

Since the deregulation of the private rented sector, landlords have been incentivised to invest by the prospect of making large capital gains and maximising their returns due to the freedom they have to increase rents and even evict tenants if that would suit their interests. In order to balance out a move to greater regulation, which is intended ultimately to reduce rental yields, we should consider using more of those incentives which have been used over many decades to promote investment (particularly that which is long-term in nature) in private rented accommodation overseas. This could include some combination of capital gains tax exemptions after a suitable period of time, depreciation allowances and making potential rental losses tax deductible. The precise nature, application and extent of these incentives should be determined by how large the government wishes the private rented sector to be and what role it wants it to play.

4. Encouraging private landlords to channel their investments into new stock

The private rented sector has been provided with the conditions to grow without any regard to how it impacts on provision in other tenures. As a result, it has eaten into the stock of both owner-occupied and social housing without alleviating the overall pressure for new homes. Future investment in the private rented sector should be strongly guided towards new-build accommodation, to increase the cash being channelled into new constructions while reducing demand (and so price inflation) for existing homes. This could be done using a combination of the incentives mentioned in point 3, above, as well as an exemption for newly-built accommodation from the indefinite tenancies and rent ceilings proposed in points 1 and 2. Central to this strategy must be the growth of institutional investors in private renting, who may be more inclined to offer long-term tenancies with rent rises agreed in advance. For them and for smaller investors in new-build, longer tenancies with predictable rent rises could be encouraged without being mandatory, on the understanding that they are contributing to the housing stock and so helping to alleviate pressure for housing overall.

These proposals would not herald a return to the rent controls that Britain experienced during and after the First and Second World Wars. These 'first generation' controls were nominal caps that, initially at least, prevented any increase in rents above, respectively, 1914 and 1939 levels. These were common in Europe at the time but were gradually replaced in most instances by 'second generation' controls which limited rent rises within and between tenancies. The system proposed above is in line with what is sometimes called 'third generation' controls, which restrict rent rises only within tenancies while allowing for market increases in between.[150]

While most economists regard first generation primary controls as damaging in the long-term, the same is not true of third generation in-tenancy rent controls. These retain an element of market pricing while creating greater stability and security for tenants (and landlords). The economist Professor Richard Arnott has written:

> ‘Unlike traditional forms of rent control, tenancy rent control does not generate excess demand but instead induces a different long-run equilibrium in the market. Compared with the uncontrolled equilibrium, the tenancy rent control equilibrium entails some distortion but also improves security of tenure. Thus, tenancy rent control may be a reasonable compromise between those who favor extensive government intervention in the housing market and those who favor little if any…
>
> ‘The big advantage of tenancy rent control is that it provides a safety valve – unrestricted rent increases between tenancies – that ensures that the performance of the housing market will not get progressively worse. Rather, tenancy rent control will lead to the establishment of a different long-run equilibrium.’[151]

Objections to rent regulation

Nevertheless, when Labour announced its plan to limit rent rises within tenancies, the Conservative Party chairman and former housing minister Grant Shapps said: ‘Evidence from Britain and around the world conclusively demonstrates that rent controls lead to poorer quality accommodation, fewer homes being rented and ultimately higher rents – hurting those most in need.’[152]

He was not alone in attacking the proposal. The British Property Foundation warned that the Labour plan risked alienating landlords and a private rented sector which had ‘attracted phenomenal investment into housing over the past two decades’.[153] The National Landlords Association went further, saying: ‘Were these proposals to become government policy it would strike a devastating blow to investment in housing of all tenures and further constrain supply at a time of real housing crisis.’[154]

RICS (the Royal Institution of Chartered Surveyors) cautioned against doing anything to ‘distort the market’ – notwithstanding that it is already distorted by housing benefit, as we have seen – and creating ‘uncertainty for investors and landlords’: ‘Our concern is this link between rent controls potentially harming supply resulting in increased rents that will impact on the consumer. At a time when much is being done to drive investment in the PRS, any proposals to interfere with the market rents will not support the delivery of more, urgently required, housing stock.’[155]

We will consider some of these objections in turn.

Won’t rent regulation damage the supply of homes?

As we have seen (in Chapter 2), the growth in the private rented sector has not led to a substantial increase in the number of homes. Small investor landlords tend to buy existing property, which is why the number of homes in the owner-occupied sector has fallen – further forcing households into the private rented sector. In fact, by exempting new-builds from a system of rent ceilings we could incentivise future investment in the sector to help increase the supply of homes.

Won't rent regulation send the private rented sector into decline again?

Rental yields would fall so there is a danger that for some existing landlords private renting will become uneconomical as an investment. But there are many other factors which influence landlords' investment decisions, as we have seen (see Chapter 4). Many of today's landlords are primarily motivated by capital gains, and some have already taken a hit on rental income in order to exploit this potential. House price inflation has been, and is likely to remain, lucrative. The Office for Budget Responsibility forecasts a further 31.4 per cent rise in house prices by 2020.[156] Of the 200,000 people planning to dip into their pensions as soon as the law changes next year, 16 per cent say they will invest in property.[157] A more responsible way of incentivising landlords to remain in the market, if that is what is desired, would be to design targeted tax incentives rather than allowing them to charge ever-higher levels of rent.

Won't in-tenancy rent ceilings increase landlords' rent demands at the outset?

Landlords will want to maximise their rental income at the beginning of a tenancy to cover potential losses if the rent falls below market levels later. This makes it likely that initial rents would be set 'above the long-run equilibrium' and fall over time.[158] But landlords already charge as much as they can at the outset of a tenancy – they are only limited by what the market will pay. This will remain the case but based on lower long-run prices.

Isn't rent regulation unnecessary in areas where supply and demand are more closely matched?

It may be that, in many areas with less pressure on housing, rent rises would be lower than the proposed ceilings allow for. Even in higher demand areas, many landlords might not put up rents for sitting tenants any faster than inflation. Where this is the case, rent regulation would not apply. The effect would be to limit those increases that would otherwise rise above inflation.

Won't regulation lead to poorer quality private rented accommodation?

Few landlords with a long-term stake in a property will want to run it down, as long as it is economical to maintain it properly. Offering them the chance to raise the rent by a small amount above what it would otherwise be limited to may be sufficient, as appears to be the case in Germany.

Concerns about the quality of housing stock should not be confined to the debate about rent regulation, however. Standards are too often dire in the private rented sector already. Only 54 per cent[159] of private rented properties met the government's Decent Homes Standard in 2010. The number of non-decent homes in private renting has been around the 1.2-1.5 million mark since 2006.[160]

This is partly a function of the shortage of available homes; until private landlords are made to compete for tenants, many of those at the lower end of the market will have no incentive to maintain standards above a bare minimum. Until then, a tougher standards regime may be required. The nature of that is beyond the scope of this paper. But if a system of rent regulation were to be imposed, enabling landlords to charge more according to the extent of improvements made to a property would be one way of incentivising good behaviour.

House building initiatives will take many years to bear fruit

It is argued, fairly, that the only sure way to curb prices effectively and for the long-term is to increase the supply of new homes to keep up with demand.[161] The failure of successive governments to ensure this happened, over several decades, has been the fundamental cause of rising housing costs.

David Cameron and Nick Clegg vowed in 2011 to 'get Britain building again', and yet there has been little progress. The Town and Country Planning Association estimates that 240,000 to 245,000 homes a year will be needed in England up to 2031.[162] Yet only 112,370 were completed in 2013/14, marginally up from 107,870 in 2010/11.[163]

Labour has now set a target, if it is in government from 2015, of building 200,000 homes a year by 2020,[164] while the Liberal Democrats want to build 300,000 a year,[165] and there is a plethora of ways being suggested to meet such aspirations, whether that is by liberalising the planning system, abolishing the green belt, taxing land more heavily to disincentivise hoarding, or giving central or local government a more active role in the process.

Whatever measures are adopted to increase house building, however, the shortage is not going to be dealt with overnight. Even if we were to assume an incoming Labour government in 2015 were to hit its target, this would only get close to meeting demand by 2020. But none of these targets is guaranteed. Moreover, it is quite conceivable that in central London, where there is only so much land to build on and potentially infinite levels of demand given the city's increasingly global status and appeal, prices will never stabilise at anything like an affordable level. There will always be more people who want to live there than there are homes in which to live, at least for the coming decades.

So a supply-side response to the housing crisis is essential, but it is a medium-term goal at best and probably more of a long-term ambition. It should not distract from the need, in the meantime, for a safety net which does not make matters worse.

Conclusion

The housing market in the UK is in a mess, and not only because too few homes have been built to accommodate a growing number of households. Past housing shortages in the UK, notably following the First and Second World Wars, have been tackled through a combination of large public programmes to support house building and rent controls to prevent landlords from profiteering at the expense of tenants. Today, far from curbing higher rents, the economic environment is encouraging landlords to absorb more and more homes into the private rented sector – but without increasing supply. The bulk of public expenditure on housing underpins this process by subsidising the spending power of a substantial portion (currently a quarter – but the numbers are rising) of tenants at the lower-end of the income scale.

If the private rented sector is to meet a larger proportion of our housing needs, including for families and those who would traditionally have preferred to buy a home, then it must offer a better deal for tenants. This means longer security of tenure and more predictability and affordability in rents. The housing benefit model has surpassed the limits of its usefulness as a safety net, because, the more people come to rely on it, the more it will inflate rents while obscuring true market prices, not least in the setting of housing benefit levels. Given the pressures on the housing market and the rise in costs across the board, landlords' investments should also be more effectively channelled into the building of new homes.

Having grown so large, it is not possible simply to remove housing benefit subsidies without leaving tenants high and dry. So the objective must be to limit and reduce housing benefit over time while providing a new safety net for those tenants who have not done as well out of the property boom as others. Indefinite leases, coupled with in-tenancy rent regulation, would go some way towards limiting further rent rises and housing benefit dependency. As well as providing greater security to the large, and growing, numbers of people in the private rented sector, the proposal advanced here would also provide some respite to the general taxpayer by limiting the future growth of the housing benefit bill. Moreover, by encouraging private sector investment to be channelled into the building of new homes, as our proposal is designed to do, it may even alleviate some of the home-buying demand which has driven prices skyward.

The framework set out here requires of policymakers a change of mindset about housing provision and the role of private landlords. If the private rented sector is to take up a much larger role in the housing market, then we need to ensure that it offers the kind of standards and security that people need to make a home in it. That may require a shift in outlook from landlords, too.

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