The future of private renting in the UK

Social Market Foundation report into the private rental sector

Michael Ball

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The Social Market Foundation

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CHAPTER ONE

The issues

Introduction

The objective of this report is to provide an assessment of the state of the private rental sector, to present some viewpoints in relation to contemporary debates over the tenure and to make some policy recommendations.

The revival of market-based private renting since the early 1990s has engendered considerable optimism. Private renting now clearly has a positive role to play in UK housing provision and this may have significant implications for both economic performance and some key social problems.

This favourable situation is at variance with that faced by most reports on private renting written in earlier decades. They had the sad feeling of being a series of post-mortems on a body that seemed dead. Any revival was widely recognised to be a pipe-dream. Then, the impossible proved possible, when a fortuitous combination of circumstances arose in the space of a few years in the 1980s and 1990s. Policy change occurred at a time of favourable shifts in economic events and led to the creation of tens of thousands of new privately rented tenancies. All the earlier decades of pessimism have now been virtually forgotten and the world of housing has been changed irrevocably.

The full impact of the revival of the privately rented sector will take many more years to work itself through the UK housing system and, as it does so, the consequences will undoubtedly influence housing policy debate. As a result, this study can only be an interim viewpoint on a long-run process of change. Even so, a considerable degree of uncertainty currently surrounds the future direction of the tenure and the policy stances that should be taken towards it.

Rental optimists see the growth of private renting as heralding a major transformation in economic and social life by greatly increasing the mobility of UK households. Governments should encourage its expansion as much as they can, they argue, particularly by reining in their generosity to the two other main tenures, owner occupation and social housing. Rental pessimists, instead, fear the effects of profit-making landlords on the lives of ordinary people, unless their behaviour is severely restrained by regulation and public agencies, and worry about a buy-to-let induced property market crash.

At the risk of spoiling the plot, it should be stated at the outset that this report will argue for a more restrained line than that of either the optimists or the pessimists. The privately rented sector has an important role to play in the UK housing scene, but it can never be expected to become the dominant housing tenure again. Instead, it has several key and special roles and investors can prosper within them. Yet, the rental market cannot be expected to undertake those roles if weighed down by excessive regulation.

Along with the growth of the new privately rented sector, there has been considerable expansion of high quality research.[1] Because much of this work is scattered and not widely known in the general policy debate, the early chapters of this report provide an overview of the privately rented sector and relate the findings to the policy arenas that are the principal themes of interest here.

The key questions

The argument is structured around a series of questions and it is worthwhile listing them at this early stage.

- Does the UK has a small rental sector by international standards?
- Why has the privately rented sector grown?
- Is it likely to continue to grow or will it wilt again?
- Would there be major economic benefits from having a larger privately rented sector on the scale of some of our continental neighbours?
- Who lives in the tenure?
- Who invests in it?
- Will there be a buy-to-let crash?
- Are new controls needed on the privately rented sector?
- Does the tenure suffer from quality and repair problems?
- Is the tax and subsidy regime fair?
- What would be a sensible set of reforms?

The first question is usefully dealt with straight away: is the UK's privately rented sector particularly small as a share of all housing provision? By international standards, the answer is that it is. This fact has formed the foundation for many of views arguing for a much higher role for the tenure in the UK. Yet, it is only true in the strict sense of *private* renting, not of renting as a whole.

As can be seen in Figure I.1, few other developed countries have such a low share of private renting.[2] Only the Netherlands in Western Europe has a lower share, though Ireland's is about the same. Interestingly, in developing countries, the private rental market is often very small, including many of the high growth S.E. Asian economies, which rely heavily on owner occupation.

Yet, it is not the case that the UK has a low share of rental housing overall, as it is in the 25-35% mid-range of countries (Figure I.1). That group includes the world's largest economies, the USA and Japan, and most of the more generally more market-oriented ones. So, ostensibly, it is not a bad group to be in.

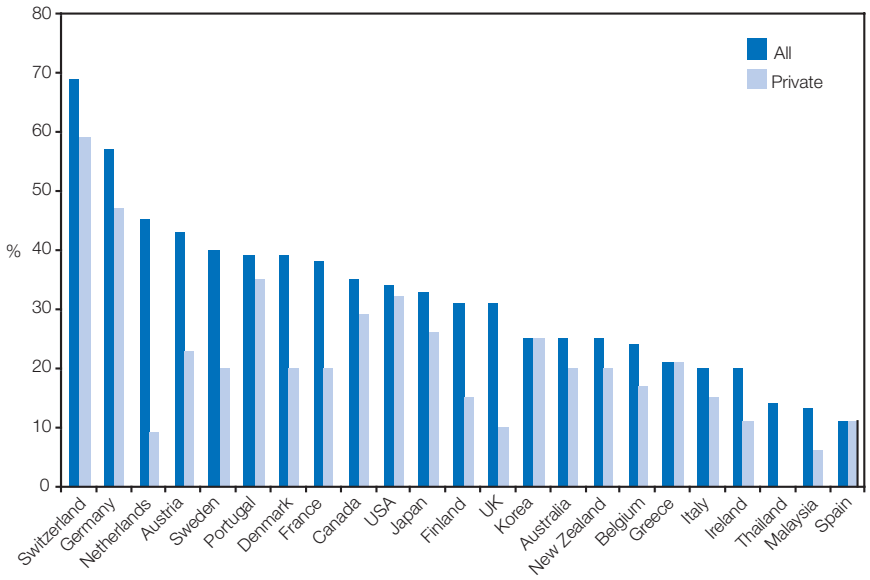
There is a distinctive group of North West European countries with the highest shares of rental housing, but they have distinctive, if mixed, sets of characteristics:

- They all have rent control policies of varying degrees of severity and scope
- Most tenants have security of tenure
- There are large tax breaks to private landlords, so that they can survive in a rent controlled environment
- Several have large social housing sectors, notably the Netherlands and Scandinavia
- Some have large numbers of foreign national residents, who cannot own and so must be renters – especially Austria and Switzerland
- Some have particular cities that are heavily renting oriented, because of local historic policies – such as Berlin, Hamburg, Vienna, Paris and Stockholm.

These characteristics of the high rental share European countries do not seem ones that is it worthwhile for the UK to emulate. Rent controls and permanent security of tenure have been successfully abolished in the UK. To go back to them would create severe market distortions and cost the Treasury dearly for no clear social or economic benefit.

Where the UK is peculiar in its renting system is the high reliance put on social rather than private renting (Figure I.2). The majority of countries have a two-thirds or more emphasis on the private sector. Another group have a

Figure 1.1 The share of rental in all housing for 23 countries[3]

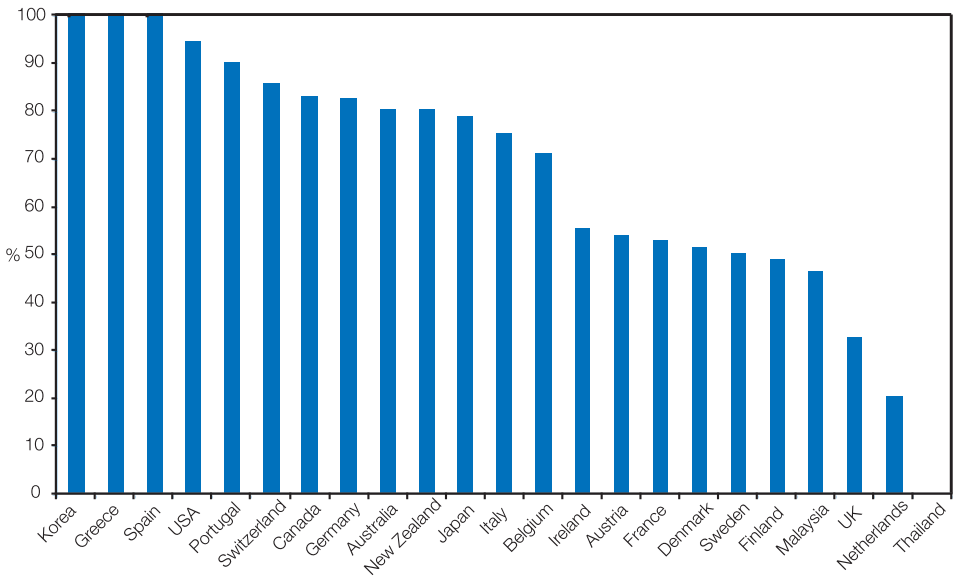


roughly 50/50 split. The UK is below a third. Only the Netherlands puts a greater emphasis on social housing than the UK, while Thailand seems to have no private renting at all. This social housing emphasis does strongly distinguish the UK from the other mid-range rental share countries noted above, because all of them rely overwhelmingly on the privately rented sector with the exception of Finland. This means that the UK's privately rented sector is likely to have some distinct characteristics from the same tenure in other countries.

Moreover, there will be a strong influence on parts of the privately rented sector, at least, from practices with respect to social housing.

This puts a study of the privately rented sector in the UK in a quandary. Ideally, it would be preferable to consider the benefits of a 'social market' approach in the social as well as the private rented sector. Yet, that is both impractical and outside the terms of reference of this review. So, only tangential comments will be made about the social rented sector.

Figure 1.2 The share of private renting in all renting for 23 countries[4]



However, the author does think that there is a need for a shift in the balance between private and social renting and for deep-seated reforms in social housing provision around 'social market' principles that should narrow the existing differences between the two tenures.

Outline of the report

The rest of this report is divided into six chapters that examine various aspects of the privately rented sector.

The first explores the long run decline of the privately rented sector, considers the reasons why it has grown again since the early 1990s and outlines the tenures' broad role within the UK system of housing provision.

Chapter 3 then looks at what sort of people rent private housing, concentrating on those who pay unsubsidised market rents. It also examines arguments about the wider importance of private renting in generating greater personal mobility. A further section considers the role played by housing benefit.

Chapter 4 switches emphasis from the user, the tenant, to the provider, the landlord. It discusses the rise of the private individual landlord and the decline of the corporate one and looks at management issues, the buy-to-let boom and whether buy-to-let will generate a housing market crash. A final section deals with the proposed introduction of Property Investment Funds and their likely roles within the privately rented sector.

Chapter 5 examines quality and safety issues over which debate has been growing in recent years. In this respect, the Housing Bill currently passing through Parliament may represent a watershed in the reintroduction of controls over private renting. There is also a discussion of repair and housing conditions and their measurement.

Chapter 6 then examines returns and taxation. It identifies unique costs in private renting not experienced in other types of housing tenure. Net returns are also described and there is a discussion of the role of taxation, which differs between types of landlord as well as across the various housing tenures.

Chapter 7 then summaries the arguments of the previous chapters and presents some policy proposals developed from the previous analysis. Readers wishing to obtain a quick overview of the arguments made in this report may wish to consult Chapter 7 first.

1 The work of Tony Crook and Peter Kemp (Univerisities of Sheffield and York respectively), for example, on investment in the privately rented sector has been extensive and exemplary. This report, except where absolutely essential, deliberately avoids the academic practice of citing references. The Joseph Rowntree Foundation website (www.jrf.org.uk) or a good internet search engine provide appropriate starting places to review the academic and professional literature.

2 The data in Figure 1.1 are only indicative of relative tenure shares, because different countries define housing tenures in distinct ways and all face measurement errors in gathering statistics.

3 Countries were selected to include most developed ones and a few high growth developing ones. Sources: M.Ball, *RICS European Housing Review*, RICS, London, 2004; United Nations; *Housing Statistics of the European Union*; Australian Bureau of Statistics; New Zealand Statistics.

4 Own calculations from sources in footnote 3.

CHAPTER TWO

The recent growth of market-based private renting

Introduction

This chapter looks at the policy causes of the long decline of the privately rented sector until the 1990s and then examines the factors that have contributed to its revival since then. It points out that the revival of private renting overall, in fact, has been fairly limited in terms of the total numbers of rental dwellings – especially since the mid-1990s. However, a vibrant free market-based rental sector has emerged and is increasingly taking over from what was once a predominantly 'regulated market' form of renting. With the growth of the new free market segment, the structure and geography of the privately rented sector has changed dramatically, as shown below.

The tenure revolution of the twentieth century

At the beginning of the twentieth century, the vast majority of people rented their accommodation. No-one knows the precise number, but over 90% of households are believed to have rented from private landlords just prior to the First World War. Then the rot set in: by the early 1950s, the numbers were down to a half; by the 1970s, to a fifth.[1] By 1991, at the tenure's nadir, only 7% of households rented privately. Another 2% also rented in association with a job or business, usually at a low or zero rent, and they confusingly are often combined in the data with the market-oriented private rented sector – giving a crude 10% approximation for private renting overall.[2]

Household numbers in any case are not the ideal measure of the enormity of the decline in market-based renting over the twentieth century, because of problems of definition with the term 'household' and changes in life styles with much smaller average household sizes in the modern era. Population figures, instead, bring out the decline of the private rented sector over a three-quarters of a century period most starkly. Before the First World War almost everyone rented, yet by 1991 less than 6% of the population was actually living in the privately rented sector. So, the tenure looked desperately close to disappearing altogether as an option for most households by the end of the twentieth century.

Common questions over the past few decades have been: what has caused the decline? Has it gone too far? What are the broader consequences?

At the outset, it should be clearly stated that much of this decline should not be decried. It has been a consequence of social progress and economic affluence. Owner occupation has replaced renting as the major tenure in the UK. That tenure now contains around 70% of all households – and it has brought with it many personal, economic and social benefits.

In fact, people have chosen to buy rather than to rent their prime residence to such an extent that virtually any person that can afford to does so nowadays. This is as true in most other advanced economies as it is in the UK. In part, this is because of the tax breaks and subsidies with which governments traditionally have favoured owner-occupation. Yet, by doing so, governments have gone with the flow. Subsidising homeownership may be condemned by economists for generating economic inefficiencies, but it is a traditional way to win votes because most people want to be

homeowners. They rightly believe that it is a cheaper personal option (which is generally true even in a tax neutral world, see Chapter 6) and, in addition, homeownership provides better personal security (security of tenure is generally absolute as long as you do not default on any outstanding mortgage loan) and ownership facilities doing what you like with your home, amongst other benefits.[3]

Owner-occupation in economic terms is an income elastic good to a greater extent than other housing tenures – so, the better-off you are the more likely you are to be a homeowner. The main criterion in household tenure choice, therefore, for most households is whether they can prudently enter homeownership.[4] There must, in other words, be some characteristic of the person or household in which they live (such as income, wealth, age or type of job) or of the rental housing supplied (particularly whether the tenant has to pay the full market rent) that makes people not part of a home-owning household.

This conclusion about consumer preferences is extremely important for the analysis of the future of the private rental sector for two reasons:

- There can be no sensible argument for going back to the notion of a dominant free market private rental sector, as in the nineteenth century. Countries in which the private rental sector is currently larger than the owner occupied one are few in number and they are characterised by supply-side distortions created by either significant rent controls and/or large tax breaks to housing investors, as was noted in Chapter 1.

- Private rented housing in the UK has to be seen in terms of fulfilling specific roles in a system of housing provision in which owner occupation is the most important housing tenure.

In Britain, much of the role of a rental sector is played by social housing, consisting of dwellings provided by local authorities, housing associations and others; now generally known as registered social landlords (RSLs). Social housing in the twentieth century has replaced parts of the previously privately rented stock with dwellings that nowadays are home for mainly low-income groups.

Social housing for many commentators, especially in the past, has been seen as the preferred rental option for low income groups. With substantial political support across the political spectrum, it rose to house around 30% of all households in the early 1980s. Since then, council house sales and much reduced building rates have lowered the tenure's share to a fifth of households and there is now much wider support for a larger privately rented sector. Even so, private renting has declined markedly among lower income groups. Nevertheless, the case for a long-term identifiably 'social' tenure, as the main rental tenure, now has less force than in the past.

Policy influences on the decline of private renting

Broad general social trends have been overlaid by the strong hand of policy.

1 Rent control

The most important policy that contributed to the decline of private renting was rent control. Rent and security of tenure controls were originally introduced in 1915 as temporary wartime measures. They stayed in various guises for the next 75 years and the remnants of rent control are only now fading away. The history of rent control in the UK was one of a series of complex but fundamentally incoherent reforms. Successive governments tried to square the circle of maintaining supply while requiring most rental housing to be let at below market terms, but none dealt with the fundamental problems until the late 1980s.

2 Unfavourable taxes

Private landlords for many years faced a highly discriminatory tax and subsidy regime meaning

that both owner-occupiers and social housing institutions received far more tax breaks and subsidies than them.[5]

3 Slow strangulation

Faced with long-term rent controls, an unfair fiscal treatment and a declining market for their services, most landlords chose the most financially attractive option of selling out to either owner occupiers or to social housing landlords. Yet, with the strict security of tenure measures in place for much of the rental stock, this could only be done when a tenant quit a tenancy. Given the attractiveness of rent levels, this was often only after long periods of time and frequently only with the death of a tenant. Unscrupulous landlords would force out tenants to gain free possession and landlords and previous tenants could charge substantial entry fees ('key money') for assigning leases to new tenants in areas of high demand, such as London.

4 A repairs and quality disaster

The abysmal returns of private landlords also discouraged them from either repairing or modernising their properties. As a result, the remaining rental housing stock declined in quality and condition for decades.

5 Enormous public expenditure and tax drain

With no repair incentives, private rental 'slums' multiplied. Though a proportion of existing houses were inherently incapable of being modern homes, others ended up being condemned simply through a long-run lack of repair and replaced by new social housing at considerable taxpayers' expense. Others were subject to waves of 'gentrification' in the 1970s and 1980s, in which previously rented dwellings were bought and improved by owner occupiers – using then highly tax efficient mortgage borrowing – and, for many years, generous improvement grants. The resultant improved properties provided substantial tax-free capital gains for their new owners; whereas if the properties had remained in the privately rented sector, their landlords would have been subject to capital gains taxation if they had improved the properties.

The end was almost nigh

Private renting continued to collapse during both the 1970s and the so-called free market Thatcher era of the 1980s. Between 1971 and 1989, the private rental sector shrank by 1.7 million dwellings – a massive 44% over an eighteen year period (Figure 2.1). It then looked as though the tenure might shrink to virtually nothing.

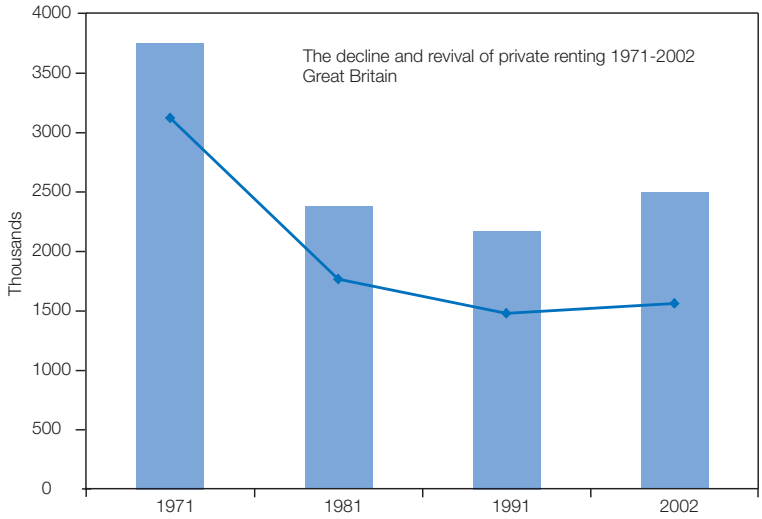
Instead, during the 1990s, the tenure began to expand again. The extent of the increase varies depending on which basis of comparison is used. When the whole privately rented sector is looked at as a share of all households, the change has been quite small (Figure 2.1), partly because the overall number of households has been growing rapidly. When the absolute change in the number of households and people living in the more purely, 'market' oriented sector[6] is examined, the change is far more dramatic (Table 2.1). The number of households rose by 27% in a decade and the number of people living in the tenure has risen by 44%. The increase in people arose because there were far less single elderly people living in controlled tenancies in 2001 and many more younger sharers. On the absolute growth measure, particularly in terms of people, the expansion of the privately rented sector has been substantial.

***Table 2.1** The privately rented sector in England & Wales, 1991 and 2001 Censuses*

	Households	People
1991	1.5	2.9
2001	1.9	4.1
% Change	27	44

NB: Excludes job-related and other not available to the public renting

Figure 2.1 The decline and revival of private renting 1971-2002



What has caused the recent growth of the rental market?

Expansion of the private rental sector has been driven by several factors. Policy changes have been important, but they have probably only been successful because there have been simultaneous changes in demand and supply relationships in the privately rented sector.

1. Direct policy reforms

The most obvious change was in the policy field. The 1988 Housing Act introduced measures that finally made market renting a viable option for landlords. It still enabled most existing controlled tenancies to remain, but introduced new forms of renting that were more market-based than previous ones. The prime measure was the introduction of the 'assured shorthold' form of tenancy, under which rental contracts could be made at freely agreed prices between landlords and tenants with security of tenure fixed only for six months. As a result of this new form of tenancy, landlords were finally confident of being able to charge market rents and of getting their property back if problems arose.

2 Financial liberalisation

The traditional cosy world of mortgage finance initially faced the bracing effects of competition in the owner-occupier loan market in the 1980s. Yet, by the 1990s, competition had spread to other areas of housing activity. As a result, there was a gradual erosion of the previously substantial interest rate premiums that most private landlords had had to pay above those offered to owner occupiers. With the advent of 'buy-to-let' mortgages in the late 1990s, the previous landlords' interest premium and associated credit supply constraints all but disappeared.

3 Reforms to housing subsidies and tax reliefs

Subsidies to both social housebuilding and to owner occupation have been curtailed over time, including the gradual abolition of mortgage interest tax relief for home owners. Housing tenures are still not 'tax neutral', but the tax benefits of home ownership over private renting, in particular, have been lessened.

4 The rising value of housing has stimulated rental investment

Many years of tight housing supply and burgeoning demand have meant that the UK has experienced one of the highest trend increases in house prices in the advanced world since the 1970s. House prices have fluctuated considerably over that time, especially in real terms, in a series of boom-bust cycles. The latest house price boom, however, has been the longest and strongest. It started in Southern

England in the mid-1990s and still shows signs of continuing, despite repeated forecasts by experts that it will eventually end (Figure 2.2). The effect has been to make house prices seem like a one-way bet for almost a decade in some areas.

The prospect of investment returns has encouraged ever more investors into the privately rented sector. This has particularly been the case over the last few years, because of problems with alternative investment opportunities. Stock markets, in particular, have exhibited substantial volatility in the wake of the late 1990s high-tech share bubble, so the privately rented sector has looked like a better bet. The sector, as a result, has experienced a torrent of investor funds of a character not seen for almost a hundred years.

Many investors have had high expectations of short-term capital gains and, uniquely in recent history, have actually seen significant annual capital gains for year after year. New landlords consequently have had no experience of the seesaw in property values that has traditionally characterised the housing market.

Such a benign market context cannot last forever, but the years of plenty have transformed the image of housing landlords. In contrast to the pariahs of yesteryear, being a landlord is now seen as a smart investment (the buy-to-let phenomenon is reviewed in more detail in Chapter 4.)

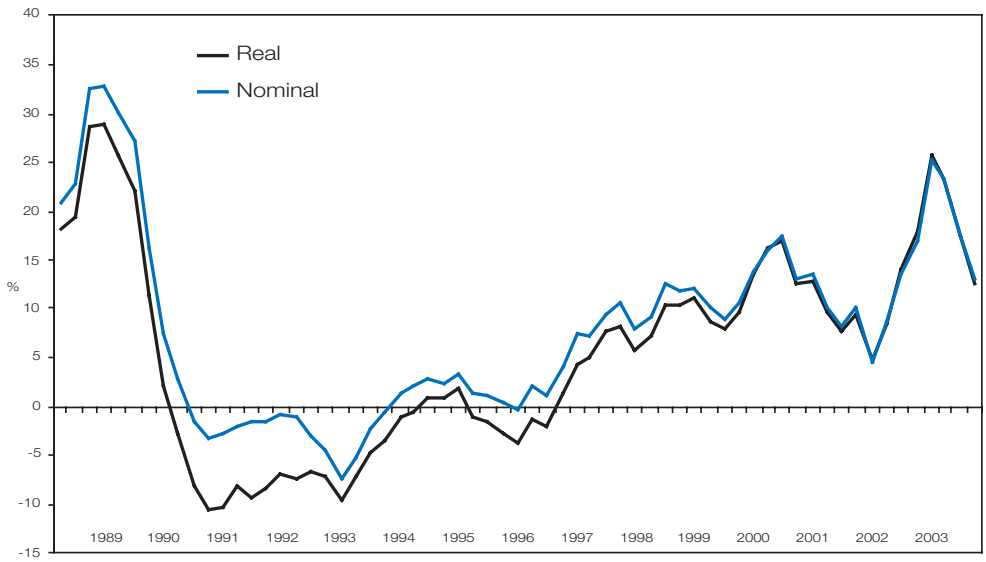
5. The growth of personal sector wealth and investment interest

Many households have higher incomes and wealth holdings than in the past and they are looking for somewhere to invest funds that will give them a good return. So, there is a much greater pool of potential investors in the general population than would have been the case twenty or thirty years ago. This rise in the cohort of potential landlords has resulted, amongst other things, from the higher general standard of living in the UK, the greater inequality in the distribution of personal sector income and wealth in recent decades, the huge pool of wealth that now exists in the owner occupied sector, the loss of traditional occupational pension schemes and greater confidence among investors that they can manage their own long-term investment affairs rather than simply leave them to financial market specialists.

6. Rising housing demand

Higher living standards mean that many people

Figure 2.2 *House price inflation 1988-2003*



want to consume more housing and/or live in smaller households. This has helped stimulate the demand for private renting as well as for other tenures. In addition, the substantial expansion of higher education since the 1980s and the British practice of university students mainly living away from the parental home have boosted a key segment of private rental demand.

7. Growing entry barriers to owner occupation have raised rental demand

Another consequence of rising house prices has been that they have discouraged new households from entering owner occupation. More people have no option but to remain as private renters than was the case in earlier years. In 1992, 44% of house purchasers were first time buyers; whereas only 26% were in 2002. Those that do enter owner occupation, furthermore, tend to do so at an older age. In 2002, almost half as few first-time buyers were under 25 when compared to 1990 and more were now in the 25-34 and 35-44 age groups. The average age of a first-time buyer is now 34, according to Halifax data.[7]

A disincentive to homeownership is the high proportions of their incomes that first-time buyers have on average to devote to mortgage repayments. The Halifax has argued that in the vast majority of English towns and cities dwellings were unaffordable for first-time buyers. Yet, if people can purchase, they still find that their outgoings are less than in renting and they enjoy substantial capital gains that more than outweigh all of their other housing costs. Their housing user cost of capital, in other words, is actually negative.

Most striking has been the increase in the average amount of money required to enter owner occupation, which was between 4-6 times greater in 2002 than a decade earlier. This cash is required to fund the non-borrowed part of house prices (the 'deposit' or 'equity') and to pay stamp duty, which is now charged on the majority of homes and is particularly onerous for first-time buyers in London, the highest priced city.

The increase in deposits has been caused by both the rise in prices and a tightening of the mortgage lending criteria.[8] By 2002, the average London first-time buyer was having to fund an estimated minimum deposit of £20,000, compared to only £3,000 in 1992 (Figure 2.3). This increase far outstripped the average rise in nominal incomes between the two periods, so that the share of their incomes many first-time buyers have to devote to savings in order to fund entry to owner occupation has grown exponentially – unless parents or other relatives can help them out.

Many first-time buyers actually have even larger deposits than this estimated minimum figure. The Halifax, for instance, suggested that its data indicated that average first-time buyers in London early in 2004 were putting down almost £40,000 deposits and very high sums elsewhere as well.

Furthermore, young first-time buyers are also more likely to have higher levels of other types of debt arising from previous further education borrowings and other loans than was the case a decade ago. Such debts would additionally inhibit the ability to save a deposit for a home. Those without very generous parental donations to cover the costs of deposits, stamp duty and the other expenses of buying a house and setting up home, consequently, have little option but to rent privately.

Capital constraints, consequently, have increasingly pushed younger households into private renting or forced them to remain there longer than equivalent cohorts would have done in earlier years. Developments in the owner occupied housing market, thus, have helped to increase the demand for rental dwellings.

8. Capital market inefficiencies stimulate renting

There is much talk currently about high levels of debt in the UK and fears about the personal and

macroeconomic consequences that may arise in the future. Even so, not all debt is bad. It can help, for example, households to find cheaper ways of living.

The arguments made above, for instance, highlight the fact that the inability to borrow to fund the costs of a deposit for home ownership represents a capital market inefficiency. This inefficiency impacts on many households constrained to rent rather than buy. This is the case for the thousands of younger households that could relatively easily cover the higher costs of borrowing implied by lower required deposits, especially as they are at the early stages of their careers and can expect rapid increases in their future incomes over a short time period.

It must have been particularly galling for those that over the course of the past five years or so have managed slowly to save for owner-occupier deposits in relatively poorly performing investment vehicles – money that could have been used to pay-off a cheap mortgage – simultaneously to observe the capital gains from owner occupation rocket and the necessary deposit stretch ever further out of reach.

The housing user cost of capital – a common technical measure of the true cost of housing – has for much of the past decade been far less in the owner occupied sector than in private renting. Yet, younger households have been less able to take advantage of that fact than have other generations or their forebears by an inability to borrow. Many have been unable to signal to lenders, the monetary authorities and policy makers that they could have more easily paid back a home owner mortgage than the rent on an equivalent dwelling plus simultaneously saving for the deposit on another owner-occupied home to which they aspired.

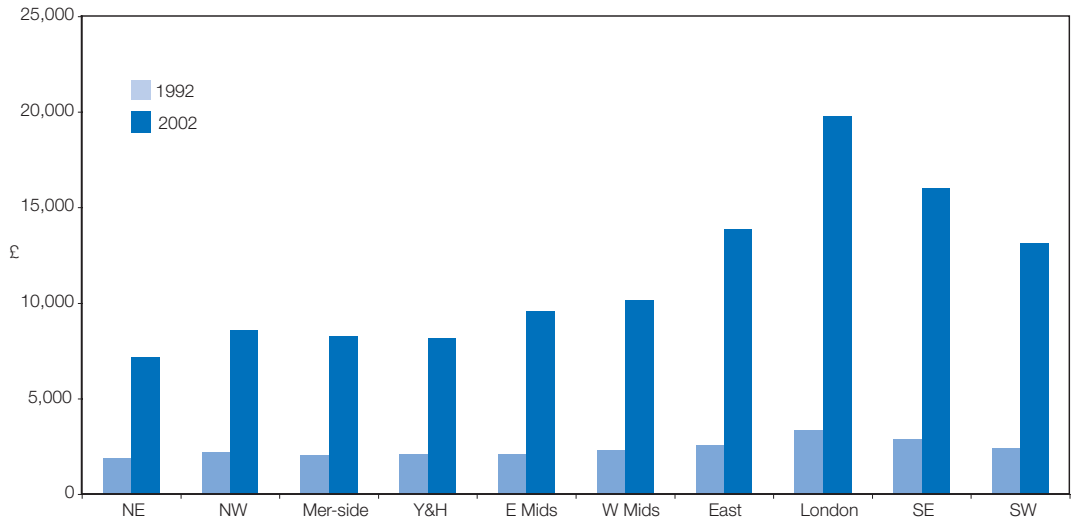
This point about barriers to entry to owner occupation demonstrates that the expansion of privately rented housing should not be unequivocally seen as an economic and social benefit. There are such benefits to be sure, as will be argued later, but the causes of the growth of private renting must be identified into its component parts for the welfare gains and losses to be properly evaluated.

A temporary rise in renter demand?

To an extent, the deposit effect just examined is a cyclical one. The house price rises of the past

Figure 2.3 *Deposit required by a first time buyer to purchase the average priced home*

(Assumes the purchaser buys an average priced dwelling at the prevailing median loan-to-value ratio.)



decade are unlikely to be repeated in the near future, so that deposits might gradually become more affordable for potential first-time buyers and the divergence between the user costs of the two tenures might come more closely into line. If the deposit barrier does weaken, it may dampen the demand for private renting.

The trend growth of house prices, however, has been particularly strong over time and supply shortages are likely to remain or intensify. In this case, the long-run demand for private renting may increase further for socially indefensible reasons, unless financial innovations and improved borrower screening reduce the current entry barriers to owner occupation.

The changing structure of private renting

The revival of private renting has been associated with considerable changes in the structure of the rental sector in terms of the types of letting, the characteristics of landlords and the geographic location of rental property. This section explores those changes and points out that they are by no means complete.

One noticeable feature is that most recent growth in private renting was actually concentrated in the early 1990s. Since then, the aggregate level has stagnated at around 2.2 million dwellings in England and 2.4 million dwelling in the UK as a whole.

When examining recent changes in private rental housing, it is important to recognise that privately renting is often treated in the available data as a catch-all category that is defined simply on the basis of the housing being neither owner occupied or socially rented. Included within it in many official housing statistics, for instance, are dwellings given to employees as part of their jobs, to relatives and it even includes those squatting. This creates problems when trying to understand developments in the privately rented sector, because many statistics combined all these disparate types of accommodation. Often, however, a distinction is made between housing that is available to the public (i.e. is rented to a non-employee or relative) and that which is not, which helps somewhat.

The relative constancy in the recent size of the privately rented sector is due to two opposing forces at work. Market-based lettings have risen, while non-market ones have fallen. The most rapid rises in market-based lettings (mainly assured shorthold tenancies) were in the years after their introduction in the late 1980s. Since the mid-1990s, the growth rate has settled down to around 2% a year. By 2001/2, nevertheless, there were 1.5 million dwellings in a tenancy that had not existed slightly over a decade before. Resident landlord lettings also expanded somewhat, encouraged by 'room-to-rent' tax reliefs, and the same is true of other forms of no security rentals, especially holiday accommodation.

In contrast, other parts of the privately rented sector have declined. As rent liberalisation in the 1980s still permitted many existing regulated tenancies to continue, there has been only a gradual decline in their number. Yet, by 2001/2, there were only a tenth of the number of regulated tenancies that existed during the late 1980s and regulated tenancies now represent only 5% of lettings.

Accommodation associated with employment and other non-housing market factors has also fallen dramatically, with almost 200,000 (40%) units disappearing in just over a decade. Job-related tenancies have declined with falling employment in industries, such as agriculture, mining and steel-making, where tied tenancies were traditionally concentrated. Other employers have taken advantage of more readily available market lettings for their staff and they and other non-market-oriented landlords have benefited from rising house prices and sold off their rental property portfolios.[9]

This process of switching towards a more market-oriented privately rented sector has

been associated with a lot of churn in the actual dwellings that are rented out. In 2001, for example, over half the dwellings owned by private individuals had been rented out for 5 years or less.

Flowing out of the privately rented sector have been properties sold to owner occupiers and, to a lesser extent, social housing institutions. Mainly flowing in have been existing dwellings previously in owner occupation. Between 1991 and 2001, some 600,000 properties were transferred from private renting to owner occupation, with an equivalent number moving in the other direction as well.[10] Some social housing has been converted to private renting, because council accommodation sold to sitting tenants may eventually end up in the privately rented sector on resale. Other new rental dwellings have resulted from refurbishments, sub-divisions and new build.

Non-market renting is still significant

Despite the fall in the non-market parts of the private rental sector, around a fifth of the privately rented sector is still in non-market forms and these parts can be expected to decline further in the future. This means that expansion of the market segment will have to be substantial in the next few years simply to maintain the privately rented sector at its current relative size.

Geographical and dwelling type differences

Where is private renting the greatest?

There are considerable geographic variations in the importance of private renting. It is highest in England (10%). Wales has slightly less (9%), followed by Scotland (7%) and Northern Ireland (5%).[11] Renting, moreover, is concentrated in particular types of city and town, and particularly in Southern England.

Table 2.2 lists the 25 local authority areas in England and Wales with the highest shares of private renting. Central London boroughs have the highest shares of both market and job-related renting, reflecting both local population characteristics and the extremely high house prices there. Other London boroughs also feature strongly in the most private-renter oriented localities, with notable geographic variations exhibited even within London alone.

***Table 2.2** The 25 English and Welsh local authority areas with the highest shares of private renting*

% of all households in the locality

	Market Renting	Other Private Renting	Total Private Renting
Westminster	30	7	36
Kensington and Chelsea	25	5	30
Camden	23	4	28
Wandsworth	22	3	25
Brighton and Hove	20	3	24
Haringey	20	4	24
Hammersmith and Fulham	20	4	23
Lambeth	18	3	21
Hastings	18	3	21
Oxford	18	6	24
Cambridge	17	6	23
Bournemouth	17	3	20
Brent	17	3	20
Newham	17	3	20
Blackpool	16	3	19
Islington	16	3	19
Ealing	16	3	18
Southampton	16	3	18
Tower Hamlets	16	3	19
Richmond upon Thames	15	4	19
Barnet	15	3	18
Torbay	15	3	18
Manchester	15	4	19
Waltham Forest	15	2	17
Hackney	15	2	17
Kingston upon Thames	14	3	17

Source: Census 2001.

Rounding errors lead to differences in totals and sub-group percentages.

Only three localities in the high renter list are outside of the South East, illustrating the

importance of renting in the highest house price part of the UK. The only other large city, apart from London, in the list is Manchester, which has an exceptionally large student population. The university towns of Oxford and Cambridge also feature, as do a swathe of seaside towns, some of which have universities. The seaside letting market is unusual in that it is seasonal, with more holiday-makers in summer and more lower income groups in winter.

Overall, concentrations of private renting can be summarised in the words south, big city, university and sea. In contrast, the lowest share of private rental areas tend to be rural areas and those old industrial areas where a tradition of owner occupation grew up, and are concentrated in the North; where property is cheaper and, hence, owner occupation is more accessible.

What types of dwelling are rented?

The typical image of a private rented dwelling is a one or two bedroomed flat. In fact, flats are in a minority. Only slightly over a third of dwellings are flats and the remainder are mainly terraced or semi-detached houses. Even so, flats comprise a significantly larger share of the privately rented sector than that of the housing stock as a whole (16%). Most are relatively spacious. Few are overcrowded on the bedroom standard and three-quarters of lettings are unfurnished.[12] Only a fifth have no access to a garden or terrace.

The stock is significantly older than in other tenures. 40% was built before 1919 and almost 60% before 1945. This reflects the fact that most privately rented properties are located in the more central parts of the UK's towns and cities.

A segmented privately rented sector

The data on tenancies and the geography of the privately rented sector highlight the key divides within it that make talk of a single sector rather meaningless. The privately rented sector when treated as a whole is as much an artefact of statistical convenience as an expression of reality.

Regulated tenancies are different from the market sector. There are separate market segments for holiday lettings, lodgings, furnished and unfurnished accommodation to name but a few. Some localities have quite a dense privately rented market. Others have only a handful of rented properties, which makes it hard to talk of a market in a meaningful sense because so few properties are traded as rental dwellings within a given time period. This absence of a rental market is more likely to be caused by demand, as households in those areas prefer other tenures, than supply, where no-one is prepared to be a landlord at current free market rents.

Segmentation exists in even the more concentrated rental localities because of different types of client – the rich and students in inner London to name but two. Some segments in such localities will also represent thin markets.

Further divisions in the privately rented sector are added by tenants on housing benefit. Benefit rules generate a distinct market segment because they influence the setting of rents. Emergency 'bed-and-breakfast' accommodation for those classified as homeless is another quasi-social part of the privately rented sector.

Private renting is a residual type of housing category as well, adding further segments. Such residual features stretch across widely different types of housing. Dwellings that form part of a legacy, for example, may be rented out when bequeathments need to be sorted out. Similarly, nominally 'rented' property – though often in practice vacant – frequently is very dilapidated housing or that located in areas of very low demand now common in rundown areas of northern English towns.

Renting in each of those situations may be temporary while owners sort out their options, wait for compulsory purchase, or come to terms with holding a worthless asset. Or renting may be simply a statistical artefact, because all

housing must be classified under one form of housing or another.

Such odd ball cases help to explain the relatively high vacancy rate in the privately rented sector, which at 6% is twice as high as in other tenures. Around half, furthermore, are what are termed 'problem', or low quality, vacancies. Turnover vacancies, however, are also high. They are three times as high as in owner occupation and 50% higher than in social housing, for reasons that are explained in Chapter 6.

When discussing the privately rented sector, it is important to recognise this myriad of segments, because what characterises one segment cannot be said to apply to others. The data unfortunately often ignore such nuances, so that averages across these divides are all that are available. It, nevertheless, is important to try and distinguish between these sectors through the statistical fog, because it tends to colour and cloud debate over the privately rented sector.

Conclusion

The 1990s witnessed a sea change in the privately rented sector with a dramatic growth in market-based renting. This growth was predominantly on the basis of the assured shorthold tenancy, which is now the default tenancy arrangement unless leases state otherwise. Expansion was facilitated by legislative reform in the late 1980s, financial liberalisation, a revival of the small landlord investor, and increased demand amongst younger cohorts of the population that increasingly found it difficult to enter owner occupation.

Private renting is geographically concentrated in the South of England, although it operates at various scales throughout the country. The tenure is particularly concentrated in large cities, university towns and seaside resorts. Most lettings are of houses, but with a greater preponderance of flats than in the housing stock as a whole. The stock of rental housing is noticeably older than average, reflecting the inner city nature of much of this tenure. Rental markets are segmented, so generalisations have to be made with care.

Most of the growth in the privately rented sector and assured shorthold tenancies occurred in the first half of the 1990s and the tenure has expanded little since then, so that the tenure seems to have stabilised at around 10-12% of the overall housing stock. There has been some growth in market-based renting and further declines in non-market-based renting since the mid-1990s, though change has been slow. The number of households in market-based renting seems to be rising on trend by about 2% a year. With non-market-based renting still a fifth of the rental stock, the privately rented sector could still decline in terms of its overall tenure share in the near future.

Nevertheless, the revival of the private rental over the past 15 years has been one of the most spectacular examples of market forces helping to generate an important, successful social change in Britain within a relatively short period of time. One downside to this conclusion is that some of the extra demand for private renting has come from younger households that have been excluded from the benefits of owner occupation by the rising cost of entering that tenure.

1 Source: ODPM.

2 1991 Population Census data. Devolution has had the unfortunate side effect of balkanising UK housing statistics, so that this section and other chapters mainly refer to data for England only. Most of the private rental sector is in England, however. All data cited can be found on the ODPM website, unless otherwise stated.

3 Less realistically, many people periodically believe housing is the best investment in the world – though this affliction is as great for potential landlords as it is for owner-occupiers.

4 This viewpoint, for example, is now coming to predominate in discussions of tenure choice in the USA, see Jones, L.D. 'Testing the central prediction of

housing tenure transition models', *Journal of Urban Economics*, 1995, and Gyourko, J. 'Access to home ownership in the United States: the impact of changing perspectives on constraints to tenure choice' in O'Sullivan, T. and Gibb, K. *Housing Economics and Public Policy*, Oxford, 2003.

5 Housing economists for years pointed out the futility of such policies, but were generally ignored.

6 This is defined here as the Census data on the renting privately furnished and unfurnished sectors in 1991 and the renting from a private landlord or letting agency in 2001.

7 Halifax data tend to differ from ODPM data, because the Halifax only has a large, but still limited (around a fifth), share of total housing market transactions.

8 Average loan-to-value ratios declined from 95% to 89% for first time buyers between 1992 and 2002 according to CML data.

9 The decline of some other industries, like local pubs, would have also contributed to the loss of employer-related accommodation.

10 English Housing Condition Survey.

11 The population census records a higher share for rental housing than these government data at 12% for England and Wales in 2001.

12 Data from *Survey of English Housing* provisional 2002/3.

CHAPTER THREE

Who rents, with what effects?

Introduction

This chapter looks at the types of people who rent houses, concentrating on the larger unsubsidised sector but also considering the impact of rent subsidies in the form of housing benefit. It examines as well the arguments put forward that the privately rented sector provides wider economic and social benefits in terms of superior opportunities for household mobility than other tenures.

A highly mobile group of people

Private renters, on average, are a highly mobile group (Table 3.1). A third of them move within a year – with getting on for a half of tenants[1] in the furnished sector staying for less than a year. Another 30% or more move within three years. This means that altogether over 60% of tenants move within 3 years and, as these data include the regulated and non-market sectors, it is reasonable to assume that the vast majority of market renters move within 3 years in both the benefit and non-rent subsidised sectors.

Mobility is phenomenal in comparison to other tenures. For instance, only 6% of those owner occupiers with mortgages and 12% of social tenants move within a year. At the other extreme, over half of home owners and 40% of social tenants stay in the same accommodation for more than ten years.

Where do new tenants come from?

Recent movers in the privately rented sector are either creating a newly-formed household or moving from one of the three tenures: owner occupation, social housing and private renting itself.[2]

A fifth are newly formed households. Around 15% come from owner occupation, many of whom previously had mortgages. They may move into renting as a stopgap in order to give more time to search for a suitable owner occupied dwelling. This type of move has probably increased with the rise in stamp duty, which now imposes a large penalty on home owners that move frequently within owner occupation. Alternatively, owner-occupiers may move into renting due to a family break-up or because they shift from a cheap to an expensive region. A much smaller group come from social housing (6% of recent movers in the privately rented sector). Some social tenants move into the privately rented sector because they can get better accommodation by doing so. Others are ejected from the social sector as bad tenants. When letting to such latter ex-social tenants, private landlords may well be unaware of their past behaviour as tenant behaviour information is not freely available.

All such entry moves into the privately rented sector, nevertheless, constitute less than half of

***Table 3.1** Length of residence by housing tenure*

		Length of residence in years					
		less than 1	1-3	3-5	5-10	10 & over	All
% shares in 2002	unfurnished	30	31	11	10	17	100
	furnished	46	32	9	6	7	100
	All rented privately	34	31	11	9	15	100
	All tenures	10	17	11	16	46	100

Source: Labour Force Survey

all moves into the tenure and they are matched by a virtually equal number of moves in the opposite direction. Over half of privately rented sector moves, therefore, are simply existing tenants moving from one private tenancy to another.

A majority of within-the-same-tenure moves is also the common experience in the other two main tenures: owner occupation and social housing. Most of the extra churn, or mobility, within the privately rented sector, therefore, does not arise through a markedly higher proportion of moves from other tenures into it compared with other tenures, but because of existing tenants moving frequently within the privately rented sector – often in the same local area.

Mainly young people

Most people who rent are young. This is particularly the case when the tenancy has a reference person paying the full-market rent without assistance from housing benefit. Over a quarter of those tenancies have a reference person aged under 25, many of whom are students.[3] Another 37% are aged between 25 and 34. So, taking these two groups together, almost two-thirds of non-rent subsidised tenants are younger people. That is a far higher proportion than the share of these age cohorts in the population as a whole.

If only assured shorthold tenancies are examined – the real market sector – the youthfulness of tenant households is probably even higher. Unfortunately, there is not an adequate breakdown in the available data to demonstrate this, but it is reasonable to assume that many mixed households with no direct family ties consist solely of young people. Making inferences from that information would suggest that the overall share of people age 34 and under living in the non-rent subsidised market part of the privately rented sector could easily be three-quarters or more of the total people living within that category. This youthful characteristic of the privately rented sector marks it out noticeably from the other housing tenures.

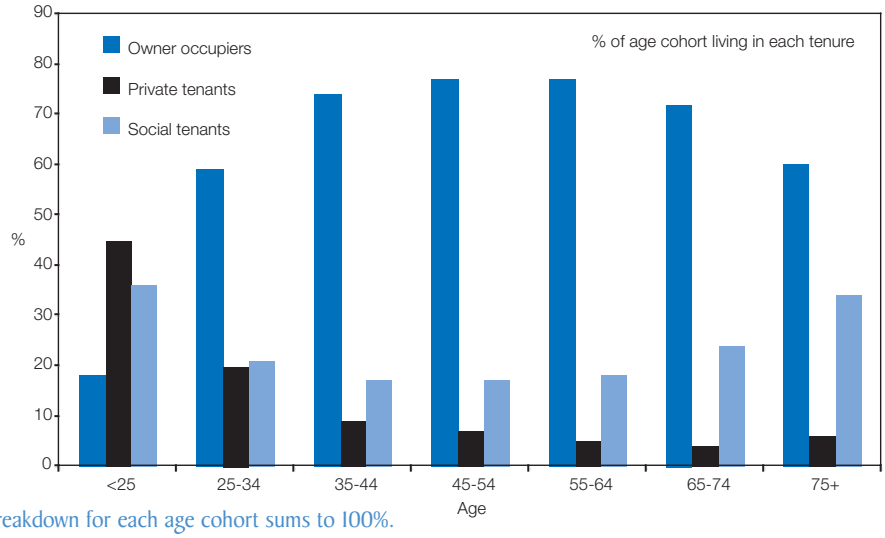
Other countries' privately rented sectors similarly have larger shares of young people in them, no matter the size of the share of private renting overall. Such a younger than average age profile of tenants, for instance, is common in the United States and Australia, particularly in the more expensive parts of the market, which is the best comparison because social renting in the UK houses many more low-income tenants than in it does in those two countries.

European countries with large private rental sectors, such as Germany and France, do have a broader range of age cohorts living in privately rented accommodation, though even there private renting still has a young household bias. The greater age range in those countries, furthermore, arises for special reasons in that it is associated with rent controls and security of tenure provisions of varying degrees of strictness. These encourage people to stay in the tenure longer, but militate against mobility, especially in areas of high housing demand.

When looking at housing tenures in terms of their importance for each adult age group within the population as a whole, the private rental sector is the most important housing tenure in the UK for under 25 year olds (Figure 3.1). For older age cohorts, owner occupation takes over the lead role, although a fifth of 25 to 34 year olds still live in the privately rented sector; whereas, amongst the 35 plus age groups, private renting is progressively under-represented with relatively small numbers in the tenure, especially in modern assured tenancies.

Younger households also pay the highest rents on average (Figure 3.2). Average non-subsidised rent levels, in fact, decline consistently as the age range increases. This is because younger households are more likely to live in the most expensive places, such as London and university towns. They often absorb the greater cost of the

*Figure 3.1 % of age group living in each of the three principle tenures**



*Tenure breakdown for each age cohort sums to 100%.

rents they pay by sharing with others.

Household types

The majority of reference person tenants are in work (54% full-time and another 8% part-time in 2002 according to the Labour Force Survey). This contrasts with social renting, where less than a quarter of reference persons are in full-time employment and over two-thirds are economically inactive. This still leaves a significant third of privately rented sector households with an economically inactive reference person. Many of the latter will be in the non-market sectors and others have their rents subsidised by housing benefit.

The household types that are most strongly represented in private renting are those sharing, lone parent and single person households; whereas couples with or without children are under-represented. To an extent this reflects, both the age distribution of tenants and the entry rules for access to social housing. Because of the uneven distribution of the total population between household types, however, their relative importance as a share of private sector tenants is somewhat distinct, as Figure 3.3 shows.

Figure 3.2 Median weekly rents by age of tenant 2001/2

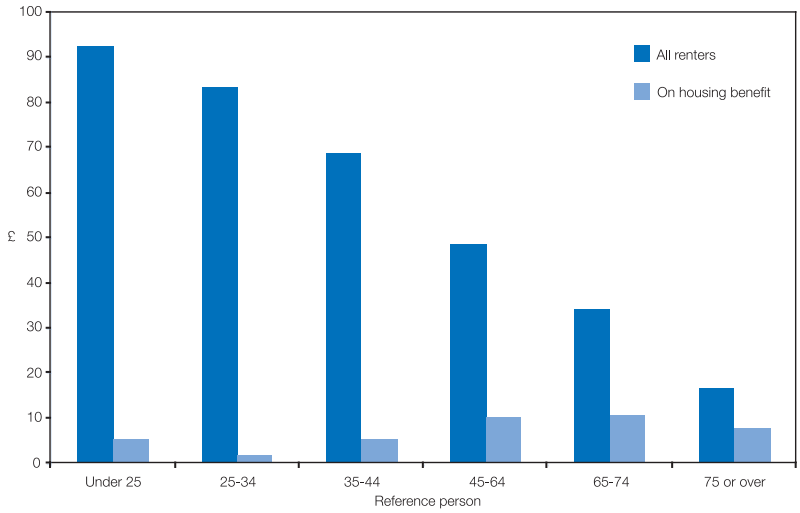
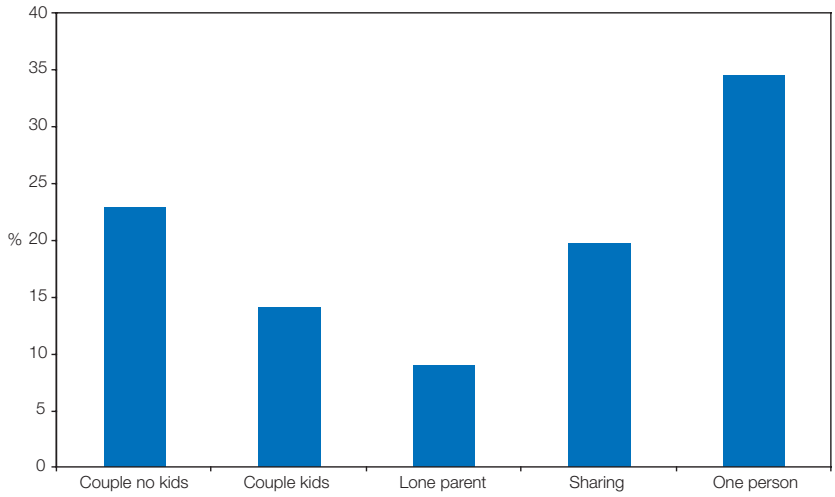


Figure 3.3 Types of households: % share of each type out of all households living in private renting



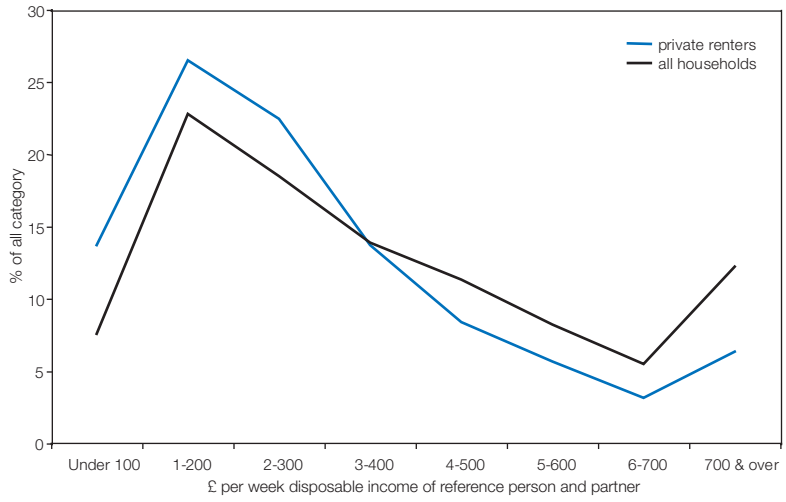
Couples, with or without children, are the largest group at almost two-fifths of households, followed by single-person households at a third, sharers at around a fifth and lone parents at around a tenth.

The distribution of income in the privately rented sector most closely represents that of the overall distribution of income as a whole, compared to the other tenures where owners tend to be better off and social renters worse off (Figure 3.4). Even so, there are somewhat more lower income private tenants than in the population as a whole, but that may reflect the relatively early stages at which such tenants are in their life cycles and ignores the future earning power of many.

Will there be enough younger households around to sustain private renting?

As younger households are the mainstay of the private rental market, it is worth examining recent population forecasts to see how robust demand is likely to be in the future. Population forecasts are an inexact science and do not fully incorporate economic influences which are particularly important with regard to the tenure location of future housing demand, but they do provide some interesting signals.

Figure 3.4 Income distribution of private renters 2001/2



The message from population forecasts is that in many areas of currently high rental demand there is going to be a significant fall in the absolute number of people in the core 15 to 44 year old age groups, the current mainstay of the privately rented sector. These age groups are only expected to fall as a proportion of the English population, by about 3% between 2002 and 2021, which does not imply any great threat to the overall pattern of rental demand. Yet, in London and other parts of the South-East, the impact is expected to be far greater, with a loss of half a million people of that age group between 2002 and 2016, 11% of the 2002 figure – because the middle range of the age pyramid will be squeezed from both sides by a growing number of the young and the old. As private renting is so important amongst this age group in the metropolis, this shift in age structure could lead to a significant downward pressure on private renting demand, unless it is offset by significant increases in other sources of demand.

Chapter 2 has already highlighted the sharp decline in the non-market element of the privately rented sector and pointed out that the market sector will have to grow significantly to sustain the privately rented share of housing provision. The demographic forecasts are another indicator that there can be little expectation on current trends and forecasts of a major growth in the privately rented sector as a whole.

Mobility and the privately rented sector

The high mobility of the privately renting tenants is often argued to be the tenure's number one economically and socially beneficial characteristic. There are several types of benefit:

1 Labour mobility

It is often claimed that labour mobility is improved, as the rapid churn of rental tenancies means that there is more likely to be accommodation available for someone wanting to move into an area in the privately rented sector than elsewhere. Transactions costs for renters are low, compared to owner occupation. Time costs may also be greater in the latter, given the time required to buy (and possibly sell in a chain) an owner occupied dwelling. Time costs are also high in social renting associated with form filling, interviews and queuing.

It has also been suggested that higher levels of private renting lower long-term unemployment rates because of this mobility effect. Research published in the mid-1990s, for example, argued that a 5% increase in a countries' home ownership rates raised unemployment rates by 1%.[4] Later investigations using more sophisticated models and micro-data, however, found a much weaker or non-existent relationship.[5]

2 Tenure of transition

Mobility makes the tenure play a useful role as a tenure of transition. This may be a life cycle effect, say, with younger households moving into the tenure and leaving it when they are older; or due to household breakdown, caused by divorce, separation or illness; or because of homelessness and poverty when no social housing is currently available.

3 Shock absorber

Mobility can also be seen in a more aggregate way as part of a process of system adjustment. It could be argued that private renting enables the housing system of a local economy to adjust more easily to disequilibrium shocks – through its labour force and transitional demand roles and because of the potential inward and outward flows of investment capital with variations in contemporary returns. Less technically, it is like the low gear of a car, helping the housing system get over difficult bits by providing the flexibility and momentum to facilitate change.

The problems of first-time buyers in entering home ownership during the current price boom, discussed in the previous chapter, is a case in point. When house prices moderate and come

more into line with first-time buyer saving abilities, younger people might end up more often buying than renting.[6] The flexibility of the rental system enables such adjustments to occur far more easily than otherwise. The first-time buyers of the late 1980s boom, in comparison, did not have such a flexible rental sector to fall back upon as prices temporarily rose and, hence, many more of them entered owner occupation with unrealistic amounts of debt and subsequently defaulted on their loans.

Care must be taken with such mobility claims, however, as they may forget aggregation problems, because what works at the individual, or micro, scale cannot be assumed to work at the aggregate, or macro, scale. Many current arguments about mobility and the privately rented sector fall foul of this issue.

Two examples illustrate aggregation problems in the context of the current debate over mobility and private renting.

1 *Relative tenure size*. It may be true that turnover is much higher in private renting than owner occupation, but it is the relative scale of these two tenures that is more important when examining the ability of anyone to move into a locality. As owner occupation is a much bigger tenure than private renting, there will usually be vastly more properties available to buy in a locality than to rent. So, owner occupation offers more choice as well as opportunities to move into most parts of the country than does private renting. Only in areas of the country and segments of the housing market where private renting is plentiful can the rental sector provide large numbers of potential transactions, such as in the Inner London flat market.

Phrases like 'we need a larger private rental sector to encourage mobility of the workforce' fail to recognise this relative size issue. The vast majority of the workforce lives in owner occupation – so, it is more likely to be true to say that the country needs more owner occupied dwellings to encourage labour mobility than rented dwellings. A larger proportion of owners, furthermore, move for job-related reasons in England than do private tenants.[7]

Similarly, to say that 'more privately rented housing is needed to deal with the consequences of the increasingly common occurrence of family break-up' are potentially wide of the mark. Most housing moves associated with divorce or separation arise in owner occupation. A recent study of new household formation caused by divorce, for example, estimated that about a fifth of the new households created by divorce move into private tenancies supported by housing benefit, but that far more move into social housing and owner occupation. In fact, given the scale of owner occupation relative to the two rental tenures and the age profile of owner occupiers, separation and divorce was mainly a within owner occupation event.[8] So, even though the privately rented sector plays a significant role, more affordable owner-occupier dwellings might be of greater numerical importance in dealing with the housing issues surrounding divorce than private renting.

2 *Supply-side constraints* The higher mobility characteristics of private renting, whatever the scale of the tenure, cannot increase the size of the housing stock in a locality and that is what determines how many people can live there.[9] More rental housing by itself will not, for example, make it easier for nurses and policemen to find somewhere to live at lower cost in areas of high demand. Only extra housing supply can do that, which takes a long time to build and to have a market impact, even when it occurs. Similarly, few extra people could move into a booming labour market unless they induced others to vacate their accommodation and move out of the same area and they could equally be active in the labour market as well. More private renting by itself, consequently, cannot deal with housing-induced labour shortages. The aggregation problem here is encapsulated in the cliché 'like moving deckchairs on the Titanic'.

There is also a composition problem as well as an aggregation one in much current debate about the privately rented sector. A distinct group of mainly younger people and a sub-sector of low-income groups on housing benefit or in rent-regulated accommodation live in the privately rented sector and it can be dangerous to generalise from their housing experiences to more general economic and social problems with key links to housing.

Private tenants and housing benefit

Housing benefit is paid directly to landlords to offset the rental payments made by tenants. In the majority of cases, it pays all or most of a tenant's rent and cost £9.5 billion in England alone in 2000/1 for all types of tenure.

Around a fifth of private tenants are on housing benefit (22% in 2002/3). Though this is a significant number, it is far less than the 60% of private tenants on benefit in 1987.[10] In contrast, the share of social tenants receiving housing benefit has stayed pretty much the same at around two-thirds of all tenants. Private tenants on housing benefit pay significantly lower rents out of their incomes than do those not receiving benefit (see Figure 3.2 above). Yet, even so, they still pay a quarter of their median income in rent on average, compared to only 6% in the social sector.

The decline in the role of housing benefit in the privately rented sector reflects the substantial transformation of the tenure over the past 15 years that has been mapped out above and elsewhere, plus the overall decline in households on housing benefit, as unemployment has fallen and benefit rules have been tightened up.

Tenants on benefit are unpopular with many landlords, with only around 20% being happy to serve that market, and many advertisements of tenancies explicitly state 'no benefit', which must seem strange to the uninitiated. The reasons for the unpopularity are threefold and relate to landlord costs, risks and the consequences for their returns:

1 Benefit tenants are regarded as more of a risk in terms of anti-social behaviour, damaging the property and generating additional repairs and management effort.

2 Perhaps more important is that, although housing benefit is generally paid directly to landlords, it is paid in arrears once the administrative system has decided how much housing benefit a tenant is eligible for, and whether the rent charge is reasonable, which can take weeks or months to process. Moreover, if a tenant's circumstances change, the whole process has to be gone through again. This can lead to landlords having to repay benefit payments, when they are reduced, and then attempt to recover the deficit in rental income from the tenant directly.

3 Finally, there is a degree of rent control arising from the administration of housing benefit, which many landlords dislike. To avoid the threat of collusion between landlords and tenants over the setting of rents, in the early 1990s a local 'reference rent' system was set up, whereby rents should not be out of line with typical local rents. Reference to the rent officer service to determine a rent can be made by the housing benefit authority, usually a local authority or a private agency to whom the task has been outsourced, when the rent is thought to be out of line. Roughly, 30% of private tenants' rents associated with housing benefit are reduced in this way.

This laudable attempt to avoid fraud through landlord-tenant collusion unfortunately ends up influencing local market rent levels. When demand is increasing in a locality, rents can be expected to rise, but this will make them out of line with current reference rents. Rent officers are trained in the art of taking the 'scarcity element' out of rents. This process is a mystery

to economic theory, where all goods and services in order to command a non-zero price have to be scarce, but has crept back into private renting in the UK through the machinations of the housing benefit system. This process has reintroduced a de facto element of rent control back into the privately rented sector.

In so far as landlords' rents are kept below free market levels they will respond in order to keep up returns to a competitive level in the way in which they did under earlier rent control: either by quitting the market, which helps to explain the decline of the benefit-related privately rented sector, or by cutting quality. Housing lobbyists and many left-leaning politicians decry the evil, exploiting landlord as a result of quality problems for housing benefit tenants and campaign for more regulation and quality control. By doing so they ignore the economics of the situation they are trying to confront, which suggests that the benefit rules have created perverse incentives for landlords that lead to quality problems.

The government is trying to deal with some of these issues in a current small-scale experiment that offers new housing benefit recipients in Pathfinder local authority areas a standard Local Housing Allowance voucher, which they can use to shop around for accommodation. This gives tenants an incentive to search and negotiate with landlords and initial results indicate that this is occurring. Yet, the introduction of a standard local allowance does not alter the fact that a certain sum of money will pay the rent of accommodation for a particular size and quality at a specific point in time. How is a standard allowance to be adjusted to take account of changes in rents arising with variations in local housing demand and supply balances and price inflation? Again, the presumption is that the housing benefit authorities will know what a proper 'fair' rent should be. The standard allowance will thus have similar consequences to reference rents in setting de facto local rent levels for private tenants on benefit.

1 Strictly these data refer to 'reference persons' – the person that the survey interviewers talked to in the household. In earlier days, they would generally have been identified as the head of household

2 The data on recent movers is based on Census 2001 information.

3 Campus accommodation is excluded from the definition of the private rented sector. A recent study has suggested, however, that half the full-time UK student population rents privately. As tenants, they are popular with landlords as they are generally well-behaved and reliable payers (Joseph Rowntree Foundation *Findings D60*, 2000).

4 Oswald, A.J., *The housing market and Europe's unemployment: A non-technical paper*, Warwick University, 1999.

5 See, for example, Green, R.K. and Hendershott, P.H., *Home ownership and the duration of unemployment: A test of the Oswald Hypothesis*, mimeo, 2001 and P. Flatau et al. *Home ownership and unemployment: does the Oswald thesis hold for Australian regions?*, mimeo, 2002.

6 If landlords sell as vacancy rates rise, moreover, they will provide much of the housing supply for such new owners to buy.

7 26% of owner reference persons moved to be nearer their job or because of a change in job, while 22% of private renters did in 2001/2, according to the *Survey of English Housing*.

8 *ODPM Summary: Effects of divorce, remarriage, separation: new households.*

9 Unless it induces people to lower their housing standards by crowding up more, which is not what most commentators would advocate.

10 P. Balchin *Housing Policy*, 1995, p114.

CHAPTER FOUR

Ownership and investment

Introduction

The previous chapter looked at the characteristics of tenants. This one switches the focus to the supply-side by looking at the characteristics of landlords and their motives and also at the rise of agent professionals as important intermediaries between landlords and tenants. In addition, landlord-tenant relations are explored and the debate over compulsory tenant deposit schemes is considered.

Having done this, the chapter focuses on some finance and investment issues. The boom in buy-to-let mortgages is examined, its significance in terms of the whole sector is put in context, and the future of mortgage lending to landlords evaluated. This is followed by consideration of the fashionable topic of Property Investment Funds (PIFs). Consultation over PIFs was announced in the 2004 Budget. They are planned to be similar to US real estate investment trusts (REITs), which now play a significant part in that country's real estate market, while versions of the approach have been developed in a number of other countries. Three interlinked PIF themes are studied: first, an examination of the general principles of this investment approach; second, a study of recent experience of similar investment vehicles in other countries, especially the USA and, third, an investigation of their potential roles in the UK's privately rented sector.

The decline of the corporate and the growth of the individual landlord[1]

Private persons have grown considerably in importance as landlords since the early 1990s and now are the owners of over two-thirds of all lettings; while companies (two-thirds of which currently are specifically property companies) have rapidly declined in significance and now represent only around 10% of all landlords. Other institutional landlords also seem to be withdrawing with their letting share now well below a fifth (Table 4.1).[2] Many of these other institutional landlords are non-commercial organisations including government departments, educational establishments and charitable trusts.

In part, the decline of the corporate landlord is associated with the long-term shrinkage of private renting, which has resulted in the selling off of estates by traditional large landlords. This accelerated once rent regulations eased in the late 1980s and was further encouraged by rising house prices from the mid-1990s onwards.

This shift away from the corporate sector is contrary to government wishes, as it believes that such landlords are more responsible, on average, and are more likely to keep a permanent presence in the sector. Whether these factors are actually true in practice is far from clear. The substantial withdrawal by companies from the sector, noted above, does not suggest any great stability in their holdings.

Unfortunately, there is actually little empirical evidence on whether one type of landlord is in any way superior to another and any current evidence might, in any case, be a poor indicator of future behaviour as the sector is going through such structural change. At present, agnosticism with regard to the issue of whether

Table 4.1 *Types of landlord*

%	1994	1998	2001
Private persons	47	61	65
Partnerships	3	4	5
Companies	25	22	13
Others	25	14	17

there is a preferable type of landlord is probably in order, while recognising that there will be a range of efficiencies and competences whatever the type of landlord, as in any other line of business.

Many landlords regard renting as a sideline to their other activities. Only 15% of dwellings in 2001 were owned by those who treated dwelling renting as their main activity (including companies as well as individuals). In contrast, there has been a big increase in recent years in 'side-line' investors. So, those that focus their activities on residential letting are in a minority. In fact, only 40% of individual landlords derive more than a quarter of their income from the industry, two-thirds have other paid employment and many others are retirees.

Companies and organisations tend to have much larger property holdings than individual landlords: 60% of them own 25 or more properties, whereas only 8% of private individuals do. This means that the decrease in corporates and the increase in sideline private investors has led to a fall in the average number of dwellings owned by the typical landlord. The median number of properties for corporates and individuals together in 2001 was only 4 (down from 9 in 1994). The range of holdings is large, furthermore, with 30% owning only one property and, at the other end of the scale, just over a third having a portfolio of 10 or more.[3]

Four types of investor

Four types of investor have been identified.[4]

- *Business landlords* These are property companies or individuals who manage residential property as a full-time job. They account for 15% of all privately rented dwellings.

- *Sideline investors* These are companies and individuals not fully employed in the sector and who regard their properties as an investment. They hold 45% of all dwellings.

- *Sideline non-investors* These are organisations and individuals letting property without regarding their holdings primarily as an investment. Like property companies, these types of landlord are declining in importance as the opportunity costs of a non-investment attitude grow.

- *Institutional landlords* They do not view their property holdings primarily as an investment and only get a minority of their income from it.

The last two types of non-investor together own 40% of all privately rented dwellings. This means that at most only three-fifths of landlords currently have what could be called a market-oriented attitude to their properties.

An industry with low economies of scale

The growth of the small landlord illustrates a fundamental characteristic of housing ownership and management in general and private landlordism in particular. There appear to be no significant economies of scale beyond a very small number of dwellings, so that a small landlord can be just as cost efficient as a larger one and may be even more so.[5] Even when they have no expertise, small landlords can hire specialists as agents or rely on the advice of solicitors and others.[6]

Financial factors do not indicate particular scale advantages either. The financial benefits of size in the privately rented sector have probably fallen with mortgage liberalisation. Larger landlords, for example, no longer get preferential mortgage terms. Instead, mortgage lenders now permit small landlords to signal their financial probity without imposing a financial penalty simply because of their size.

In addition, the risk pooling benefits of owning a larger, dispersed housing stock are likely to be small. Any landlord may end up buying a 'lemon' of a property or by luck purchase an

exceptionally well-performing one. Yet, the investment pooling benefits that smooth out such potential variations end at quite small scales of holdings. Larger pooling benefits from geographic diversification are also weak. The various regions of the UK's housing market over the long run tend to move too closely in unison for a geographically spread out portfolio to offer much return smoothing. Investor landlords would be better advised to pool their property assets with other types of investment or internationally.

The scale economies argument is an important one for policy, as it suggests that there is no fundamental economic reason why the ownership structure of the privately rented sector should be of general policy concern. What exists over time may well change, as has been observed in recent years, but that should be regarded as indicative of the dynamism of market forces rather than a signal for government action. This, of course, is not to say that governments should not encourage innovative organisational forms, but these need to have specific justifications.

Are large landlords doomed?

International evidence seems to point to the private rental sector being a haven for the small investor. This does not mean there is not a significant role for the larger investor, rather that there can be no expectation that large-scale consolidation will ever come to privately rented sector investment.

There are several reasons why larger investors are attracted and discouraged from investing in the privately rented sector. Information limitations, regulation and uncertainty, plus reputation and management costs can act as deterrents; whereas it has the traditional attractions of being a relatively risk-free, long-term investment with a different cyclical performance from other asset classes.[7] There is also the opportunity to use expertise and acumen to spot changing market trends and other profitable opportunities. In addition, larger investors are being currently boosted by financial innovations and the diffusion of innovations from other property sectors, such as in facilities management and in the provision of a wide range of ancillary services and product packages.[8] There is also anecdotal evidence of renewed large investor interest in residential property. The barriers to large investors, however, are still quite high, so that mechanisms to reduce them are likely to lead to greater flows of capital from such sources into the privately rented sector.

Landlord-tenant relationships

Despite the cultural change in public attitudes to private landlords in recent years, a poor image lingers in some quarters. The ghosts of the likes of the infamous Peter Rachman have not been finally laid to rest. He helped to bring down a government in the early 1960s and spawned salacious media coverage, reports and legislation against landlord malpractices. Yet, such operators existed in an era when rent controls could bring sudden wealth when a tenant quit – giving a huge incentive to some landlords to misbehave. This history, consequently, should be remembered more for highlighting the fact that regulation can channel behaviour in unfortunate and unintended ways, rather than as illustration of any innate temperament of landlords.

The juxtaposition of the 'good' and 'bad' amongst landlords, none the less, is a commonplace of policy debate in a way in which it is not for many other activities. Landlords, unsurprisingly, repost to such labels with the notion of the 'good' and 'bad' tenant. A third of landlords surveyed in 2001, in fact, had recently sought possession on grounds of tenant behaviour – and only half thought the process was effective.

In part, the rush to categorise the behaviour of landlords and tenants is because property transactions are complex and replete with

information deficiencies and asymmetries. On the one hand, landlords do not know for sure whether new tenants will pay the rent nor that they will treat the property well; on the other hand, new tenants cannot properly assess landlords' true reservation rents nor whether they will respect fully the terms of the contract.

Furthermore, the landlord-tenant relationship is one where each can impose high costs on the other, which can lead to personal friction. There are high transactions costs if the relationship completely breaks down: both for tenants in having to look for a new home and for landlords in searching for a new, high quality, tenant. This situation leaves scope for continual bargaining and the potential for opportunistic behaviour.

Recognition of such potential landlord-tenant issues is not the equivalent of a red card implying inevitable market failure and the need for a regulator to fix the problems. Instead, there are many market responses to such potential difficulties. An example is the requirement for deposits from tenants to encourage them to pay the rent in a timely manner and look after the dwelling. In fact, more than three-fifths of market lettings require deposits and 70% references to improve knowledge about potential tenants.

In general, the potential for problems to arise because either party does not have full information about the other acts as an incentive for both landlords and tenants to get on with each other. Such a mutually beneficial strategy minimises the stress, complications and costs of disputes. Such strategies are less likely to exist in the more distant, bureaucratic and rule-bound settings common in social housing. This may help to account for the average higher esteem private tenants have for their landlords than do social tenants. Private landlords, for example, score better in surveys of whether tenants are kept informed than do social landlords, and only 5% of private tenants, when asked, are very dissatisfied with their landlords in contrast to 11% of social tenants.[9]

Even so, such market-based solutions would be improved if some transaction costs were lowered, especially the costs of acquiring information. Tenants, for example, are often ignorant of their rights and either landlord or tenant may be unaware of the importance of good-natured negotiation. Landlords and their agents repeatedly complain in surveys about the difficulties of getting public information. This includes such important matters as fire safety – one of the major concerns in current proposed legislative change with regard to houses in multiple occupancy.

Modern technology has not been used to improve information as effectively as in many other spheres. There is no privately rented sector clearing-house web-site at either national or local government levels. Both the ODPM and the Inland Revenue, for example, have web-based information but they deal only with selected matters that fall under their respective jurisdictions.

Information is a public good and much of the necessary information for both landlords and tenants is about public regulations and policies. This would consequently seem to be an area where public policy could significantly be improved at limited cost with major benefit.

The problem of tenant deposit disputes

There has been widespread concern that some landlords abuse tenant deposits by failing to return them or withholding all or part on the basis of fictitious claims for damage. Similarly, it is reported that some tenants fail to pay the last month or two's rent, perhaps for fear of not getting back their deposits or because they do not want to accept responsibility for damage they might have caused.

Organisations such as the Association of Residential Letting Agents (ARLA) and Shelter are arguing for the need for a public Tenancy Deposit Scheme to hold deposits and

adjudicate over deposit disputes, but the government in 2003 pulled out of initial proposals to set up one on the grounds that voluntary schemes were being initiated and, so, it was better to wait and see whether they worked before reviewing the situation. In response, ARLA is setting up its own voluntary Tenancy Deposit Scheme for Regulated Agents, which came on stream in May, 2004. In it, landlords and tenants agree to adjudication by a third party over deposit disputes and an independent company has been set up to undertake that role.

The theoretical argument that it is in both landlords' and tenants' best interests to get along, outlined in the previous section, is obviously weaker when the relationship is coming to an end. Mutual suspicion consequently may easily replace co-operation. So, it is unsurprising that deposit dispute issues are contentious.

In terms of policy options, the government's current stance would seem to make sense. The notion of an independent adjudicator, whether they hold the deposits or not, is akin to an insurance policy. Hopefully, it is not needed but it provides a cushion when required. When a third party scheme is well-run, moreover, potential abuses are lowered and overall market efficiency is increased.

Most insurance, however, is costly to provide and tenant deposit adjudication and/or holding themselves similarly involve expenses. The costs of the system may be met simply by charging those that use the adjudication process or by charging a flat, or risk-related, fee on all that want to use the scheme. If only those who actually use the dispute process are charged costs, the charges imposed on them will be too high because there would then be free-riding of all of those that want the implicit insurance of an adjudication system but turn out not to need to make a claim. A mixed user cost and general fee would be more efficient and equitable.

Should a deposit adjudication scheme be compulsory? In most markets, insurance is voluntary; in some, it is compulsory. In the privately rented sector, some tenants and landlords will be more confident of a low risk of deposit disputes than others, so that the former are less likely to want to pay the necessary deposit-related insurance premium than the others. A compulsory scheme would, however, impose costs on all landlords and tenants, so that those that did not want the insurance would be subsidising those that did. If the government provided the scheme, they would either have to charge user fees and/or impose a compulsory charge on all – leading to the same problems outlined above – or the general taxpayer would be subsidising landlords and tenants for no good reason.

The only clear economic case for government intervention is when private insurance markets cannot be formed. This generally occurs when bad risks crowd out a feasible market (adverse selection). Yet, this seems unlikely to be the case with tenant deposit dispute schemes. The modern private rental market is only 15 years old and already private schemes are coming on stream. Following ARLA's lead, other independent adjudicators might well soon set up and compete for business. The competition would be good for keeping the costs of adjudication down. A compulsory public scheme would face no similar competitive pressures. All told, the government seems wise to wait.

The rise of professionalism

Another market-based solution to potential landlord-tenant problems is the existence of professional lettings agents. For a fee, they manage their properties and deal with tenants and their problems on landlords' behalf. This avoids the need for direct personal involvement by property investors; increases liquidity in local markets as investors no longer have to have a local presence; and leads to a self-selection process through which landlords who are least interested or adept at mastering the landlord-tenant relationship can opt out of it and hire an expert.

Many landlords now use an agent to manage their properties. Just under 60% of dwellings 'accessible to the public' were let and/or managed by agents in 2001 and the percentage may well have risen since then. Dwellings let and managed by agents tend to have more formalised management processes and are in a better state of repair than others. As the market rental sector is relatively young, it is to be expected that the 'demonstration effect' of such practices on other lettings is likely to be high and, so, further improvements in lettings and management processes are likely in the future.

As the market-based component of the privately rented sector has grown over the past fifteen years, there has been a parallel blossoming of the number of agencies offering lettings and management services. Many existing estate agents have set up or extended their lettings departments and built up operations to assist landlords in buy-to-let. Others have set up as purely lettings agents. This has greatly increased market information in the sector both for landlords and tenants and, as a result, significantly improved the operation of the market.

The ease of entry and exit to the agency business are high. Agency fees and services, therefore, are set in a competitive environment. This has encouraged the widespread adoption by landlords of agency services. Continuing competitive pressures should both increase the long-run quality of housing management and reduce its cost.

Not all lettings agents, of course, are efficient or honest and there are calls for compulsory registration. The case for this, however, does not seems strong and market forces are likely to be more effective at weeding out the cowboys.

The buy-to-let boom

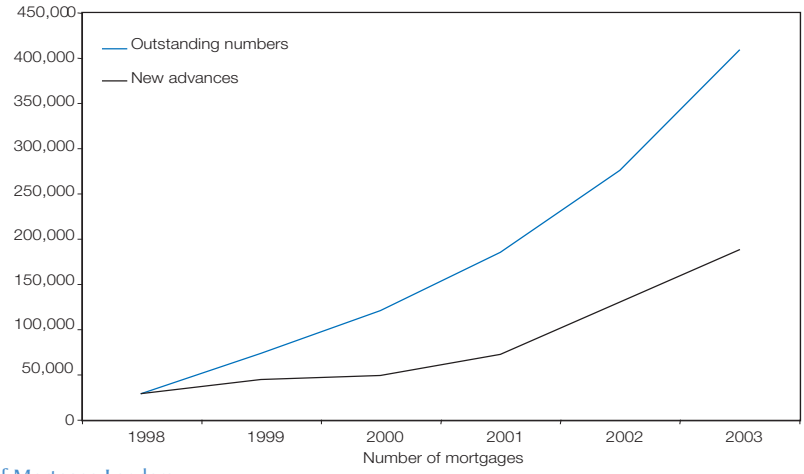
Competition amongst mortgage lenders was argued in Chapter 2 to be one of the main reasons why market-based renting has expanded so significantly over the past 15 years. By the late 1990s, mortgage lenders began to brand mortgage products specifically as 'buy-to-let' mortgages in association with ARLA as a means of encouraging additional individual investors.

The spectacular growth of buy-to-let can be seen in Figure 4.1. By the end of 2003, there were over 400,000 buy-to-let mortgages – up from zero prior to 1998 when the scheme was launched – with an outstanding mortgage value of £39bn. In addition, industry sources suggest that another £10bn or so may be lent to landlords through other mortgage instruments, giving a rough outstanding total loan figure to the sector of £50bn.

Not all buy-to-let mortgages represent new rental dwellings coming onto the market. Though newly issued buy-to-let mortgages are often associated with extra purchases of rental dwellings, many are re-mortgages of existing properties to take advantage of improved terms and better interest rates. This may help to explain the paradox whereby buy-to-let data seem to suggest a significant expansion of the market-rental sector in recent years, whereas government surveys do not.

The growth in buy-to-let also has to be put in context of the overall size of the privately rented sector. Total buy-to-let mortgages represent less than a fifth of privately rented dwellings as a whole and less than a quarter of the market-sector specifically. Back of the envelope calculations suggest that under a third of the privately rented sector stock is mortgaged to any significant degree. These calculations are confirmed by the English House Condition Survey, which reported that in 2001 only 31% of privately rented sector dwellings were mortgaged. Even if all these mortgages were concentrated in the active investor sectors identified above, it would represent only half of their holdings. Whichever way the numbers are looked at, consequently, it would seem that the privately rented sector is currently under- rather than over-mortgaged.

Figure 4.1 The Buy-to-let Boom



Source Council of Mortgage Lenders

A lack of financial sophistication apparent

Low sector indebtedness ratios suggest that many landlords are not taking advantage of the benefits of financial gearing. Mortgage borrowing can raise investor returns as long as their total rental returns are greater than the cost of borrowing net of tax. In such situations landlords can leverage the returns on their own capital significantly by taking out mortgages up to prudent levels that shield them against mortgage default risk.[10] Many landlords, surprisingly, fail to do this; even though mortgage interest payments are tax deductible, meaning that the net-of-tax cost of borrowing is particularly attractive.

The low gearing characteristic of the privately rented sector suggests that:

- Many private landlords are still relatively financially unsophisticated
- Mortgage lending to private landlords will grow significantly in the future
- The private rental sector could operate on lower gross returns, if potential gearing and associated tax effects were adopted more effectively.

Will buy-to-let cause a housing market crash?

The expansion of the buy-to-let market has accelerated in recent years and led some commentators to predict a bubble-style crash as a result in the near future on the grounds of what goes up must come down. On this doom-laden scenario, problems will spill over into the housing market as a whole and be the main reason why house prices rapidly fall by 20 to 50% in nominal terms depending on the sources in order to realign themselves back onto their long-run ratio with average earnings.

How many buy-to-let investors are actually teetering on a financial precipice is disputed. While some commentators suggest the number may be high, mortgage industry representatives point to the strict lending criteria that are in place. In 2003, the maximum loan-to-value ratio was 80% and the minimum rental cover of mortgage repayments was 130%, giving a significant cushion before financial oblivion is reached. The probability of a buy-to-let crash, moreover, is diminished when the privately rented sector is viewed overall. Rather than being over-borrowed, it is under-borrowed, as explained above.

One version of a crash scenario is that it would be triggered by an unexpected rise in the rental vacancy rate, caused by supply outstripping

demand. Why such large increases in vacancies should take place is a mystery in a situation of general housing shortages. Even in the unlikely event of a sudden surge in vacancies, it is unclear why the impact should be concentrated on the relatively small heavily-mortgaged part of the privately rented sector.

Current increases in rental supply, as shown in Chapter 2, do not, in any case, seem that great. Yet rapidly expanding supply, rather than collapsing demand, is likely to be a pre-requisite of any marked rise in vacancies. On the available data, therefore, over-supply problems in the privately rented sector, even if they were to occur, would most likely be localised rather than national events.

Another crash scenario bases itself on market sentiment. As soon as overoptimistic buy-to-let investors see that house prices are no longer rising rapidly, they will try to sell off their holdings and, in doing so, accelerate the overall housing market into a slump. For a general slump to occur, there has to be a significant excess of sellers in both the rental and owner occupier markets that generates a large number of vacancies. This is again unlikely in a nation facing marked housing shortages. If sales of rental properties arose, for example, shortages would grow in private renting pushing up rents and, therefore, returns. Selling landlords could also probably reduce their dwelling holdings by selling out to new or existing owner occupiers, even with a slight softening of prices. Activity in rental and home owner markets tends to move in different directions over the course of the housing market cycle as households delay or speed up their planned entry to homeownership depending on market conditions.

An issue here is whether new buy-to-let landlords are in the business of home renting for the long haul or simply for short-term capital gains. There is obviously no clear way of knowing precisely. Yet the expectation must be that many are in for the long-term. Many, for example, claim that private rental investment is part of a long-term strategy to build up a pension nest egg. In a recent ARLA survey in February 2004, more than 90% of landlord respondents said that they would not sell if house prices fell and nearly two-thirds expected to hold their properties for at least ten years. Housing transactions have high costs, which deter strategies of rapid entry and exit. Landlord investors have the near certain prospect of long-run rises in house prices, so they would jeopardise long-term gains if they sold up in a falling market.

Although forecasting is an uncertain business, the prospect, therefore, must be that markets will work in the sense of bringing about adjustments that do not involve a temporary and bloody market collapse. If disequilibrium did occur, supply is more likely to be brought back into balance with demand by some gradual stock-adjustment mechanism rather than through a cataclysmic crash process induced by defaulting buy-to-let landlords.

Property Investment Funds (PIFs)

Earlier, it was pointed out that there are some significant barriers to investment by large organisations in the privately rented sector. PIFs are the most recent proposal to improve the situation and the government is currently contemplating their introduction. This section evaluates the potential benefits and limitations of such an innovation. Part of what follows is somewhat more technical than the rest, as it outlines the general principles and operation of a particular type of property investment vehicle, so some readers may wish to omit it and go directly to the discussion of residential PIFs.

Background

Tax-efficiency is the central feature of Property Investment Funds (PIFs) and it is hoped that they will encourage investment in residential property. Yet, because they are going to be general property investment vehicles, it is useful to explain their broad features first, before

examining their potential roles in the UK's privately rented sector specifically.

PIFS do not exist in the UK at present. The UK property industry has been lobbying for a number of years for the introduction of a US Real Estate Investment Trust (REIT) style vehicle for all classes of property. After several rebuffs, the Treasury in documents associated with the November 2003 Budget Statement suggested that they might finally be introduced soon and a consultation period followed the March 2004 Budget.

REITs originated in the United States in the 1960s, since when the name REIT has become the generic term internationally. They have also been introduced under a variety of nomenclatures in a range of countries, including the Netherlands, Belgium, France, Turkey, Japan, Singapore, Hong Kong, Taiwan and Australia. They are also currently being proposed for a number of other countries, including Germany, leaving the UK increasingly the odd one out.

After all, tax haven property companies – and even foreign-based REITs in principle – can invest in the UK, so that there is a substantial threat that indirect property investment vehicles will increasingly quit the UK for elsewhere. That would both threaten highly-paid British jobs and rob the Treasury of tax income.

The decline in UK residential corporate activity, noted earlier, which in value in the property world is relatively small change, has been mirrored in much higher value commercial property, where institutional holdings in property relative to other asset classes have fallen substantially over the past two decades[11] at the same time as property funds have gone off-shore to limit tax exposure. So, there is a growing need to reverse the dramatic relative UK decline in investment in property of all types as an asset class over the past decade or more.

Global pressure apart, REITs are clearly a fashionable financial vehicle; one that may increase liquidity and investment in UK private rental housing, as is explained below.

Operation

The rules for REITs vary between countries, but the principles are common and straightforward. REITs issue shares and borrow under clearly defined regulatory formulae. They act predominantly as pure low-risk property investment vehicles, distributing the majority of their net rental income to investors under advantageous tax rules. They tend to specialise in one type of property class, such as residential, mobile homes, retail, offices and so on.

With regard to ownership and activities, a REIT owns and manages a stock of property assets (or, more usually has them managed on its behalf). The UK property industry[12] proposes a closed-end REIT structure, with a fixed number of shares sold at one point in time, after which the REITs' shares trade on a secondary market, typically the Stock Exchange. Ownership is passive in that REITs usually are not permitted to undertake the more risky activities associated with property, including new development and refurbishment or extensive dealing in property assets through an active policy of purchases and sales.[13]

There are country-specific rules on how many shares a REIT may issue and what proportion of assets can be funded through borrowing. For example, in Belgium, gearing is limited to 50%; yet in France it is unlimited. Typically, the regulatory framework for REITs imposes gearing (leverage) ratios that are low by property market standards. A common suggestion in the UK, for example, is that borrowing should be capped at only 50% of a PIF's assets, with the rest financed by equity.

The net income from REIT holdings of property assets are mainly passed through directly to shareholders as dividends (a minimum of 90% under US rules; somewhat different shares elsewhere). REIT profits are not subject to

corporation tax, but shareholders pay tax on their dividend income and on any capital gains they have from increases in REIT share prices.[14] In the UK, they would also pay 0.25% stamp duty on any share transactions they undertake at currently prevailing rates.

The benefits of the REIT model

There are several suggested benefits of REITs:

1 Tax efficient vehicle for indirect property investment

As REITs are not subject to corporation tax, unlike traditional property companies, and shareholders receive higher proportions of rental income from property as dividends benefiting REIT shareholders over many other indirect investment possibilities. Currently, much indirect property investment (such as purchasing the shares of a property company) is subject to double taxation in comparison to direct ownership, which has encouraged the decline of the indirect form of property holding in the UK. The REIT vehicle by removing this double-taxation effect may encourage more investors to own property indirectly through a UK PIF's shares rather than to hold it directly in a non-corporate form (for example, as a direct investor or an owner-occupier), as an institution (pension and other funds pay no tax on their income derived directly from property) or via an off-shore fund.

The removal of the double-taxation effect with REITs does not necessarily mean that the government loses out in tax revenues. Instead it is generally argued that the direct tax effect of the changeover is limited or may be even positive for Exchequer revenues. This may occur, for example, because any capital gains on REIT shares are more transparent and immediate than are accounting revaluations of property holdings in a property company's portfolio of assets or the realisations of capital gains by individual property investors.

The tax take could also be significant on a one-off basis, if large amounts of existing property were put into REIT structures and a conversion tax was levied. For example, the Wellcome Trust, the medical charity, is contemplating converting its large holdings of residential properties in up-market South Kensington in London to a PIF, when permitted. £200m of properties would enter the Wellcome PIF, giving the Trust a huge cash windfall of which the government might well insist on having a share as a conversion or windfall tax.

For all REITs, moreover, it is argued that the REIT vehicle encourages investor interest in property share holding and dealing, so that the stamp duty income from share purchase and transactions on the secondary market help to offset any potential losses of direct tax revenue.

Such arguments obviously depend on estimates of structural changes in property market investment behaviour and holdings. The Inland Revenue has traditionally been wary, emphasising the potential tax losses of a wholesale switch of property assets to the REIT formulation and the privileged status property would have over other asset classes, with the latter often not having equivalent tax efficient investment vehicles. General and government opinion seems to be moving against such a pessimistic perspective.

2 Increase market liquidity and efficiency

Property is an illiquid asset. It takes both time to buy and sell property directly and transactions costs are high. This means that investors cannot alter their exposures in a timely manner to changed market or personal circumstances.

Owning the shares of traded REITs partly removes these problems as their shares are easy and cheap to buy and sell. In so far as REITs lower the transaction costs and speed up the overall time of changing investment positions, both the scale of investment in property and its liquidity should be increased. This should raise the efficiency of property markets.

Being such a transmission mechanism, however, implies that REIT shares contain a degree of volatility, because of the mismatch between the investment characteristics of their traded shares and of the underlying assets they own. A REIT's own investments, after all, are direct property investment. So, they cannot rapidly alter their own investment positions at limited cost in contrast to the holders of their shares. This imbalance is likely, in principle, to lead to a higher degree of volatility in their share prices than that of returns in the direct market.[15]

Experience in other countries has varied, partly because of the time horizons over which REIT shares have been traded and partly because of the rules and regulations associated with REIT stocks. In some countries, such as Belgium, REIT performance has tended to be in line with direct property. In Australia, in particular, (where they are called Listed Property Trusts, LPTs) LPT shares have become hot and heavily traded stocks in recent years. In the USA, experience has been different with a hybrid performance of REITs that has been somewhere in between the volatilities of direct property and equities.

3 Lowering the lumpiness of property investment

Direct property investment is the acquisition of a lumpy asset in that whole buildings or, with residential, dwellings have to be purchased. The funds required may be too much for many small investors and with larger and more expensive structures, even for many major investors. The scale of any allocation of funds required, furthermore, may skew investors' overall holdings away from optimal portfolio mixes. Lumpiness, therefore, discourages many investors from direct property investment.

In so far as REITs extend the range and divisibility of indirect property investments, they may reduce lumpiness effects in property investment. In an ideal world, REITs act like wholesalers do in any market: expertly purchasing large bundles of assets and then breaking down return outcomes into share-unit portions as quasi-pass-through vehicles for institutional and individual investors.

The crux of the REIT argument, therefore, is that they improve liquidity and enable a wider array of investors to enter property markets. This benefits property markets and investors who have property, as an asset class, to add easily and cheaply to their portfolios. The improvement in liquidity for property markets means that they benefit from a greater flow of funds and more competitive pressures. This increases their scope and depth and, hence, their efficiency. Nonetheless, the investor impact is a particularly important REIT benefit as property investment is typically a safe, low yielding asset and fluctuations in property returns are only weakly correlated with those of other financial assets.

The above characteristics could be said to be true of many indirect forms of property investment relative to direct investment, but the REIT approach is argued to accentuate the positive and disregard several negative features of indirect property investment (usually associated with the risk of investing in property development that REITs are not allowed to undertake). This means, so it is argued, that REIT property values have a lower tendency to trade at less than underlying net asset value (NAV) than is the case with other indirect property investment vehicles. Consequently, REITs are said to have a particularly effective impact on property efficiency.

4 Transparency

In order to protect share values and, thus, their jobs and bonuses, REIT managements have a strong incentive to be as transparent as possible about property asset holdings and performance. In order to achieve this, REITs tend to undertake frequent valuations of their real estate assets. Moreover, they tend to invest only in prime property and standardised asset ranges. Transparency needs also help to explain why limited numbers of REITs invest in more than one property class, even when they are

permitted to by legislation. In the USA, for example, the main residential REITs are separate entities from retail and office ones.

Yet, REITs can still gain bad reputations through overly-risky investments or other forms of under-performance (as they did in the USA prior to the late 1980s). So, they can also suffer problems and find their shares trading at huge discounts to NAV. The ratio of share price to NAV, consequently, is also about prudent management and sensible and transparent asset holdings as well as the tax efficiency of the REIT structure. This highlights the importance of setting up a REIT regulatory framework that creates the appropriate incentive structures.

Overseas experience

The REIT structure helps to explain the runaway success of such property ownership vehicles in the countries where they have existed over the past decade. This is especially the case in Australia and the USA.

The growth of REITs in number and value in the USA since the early 1970s is shown in Figure 4.2. The spectacular rise in their capitalisation value over the past decade is clearly apparent in the diagram, though mergers and acquisitions have reduced their number by about a quarter since the mid-1990s peak.

The expansion of US REITs had much to do with reforms to the country's tax laws in the 1980s, which made other forms of property ownership less attractive; favourable tax conditions when converting existing real estate holdings into the REIT format; and in property market conditions at the time. These factors in combination turned REITs into a growth stock in the 1990s, raising market expectations of rapid capital gains which pushed REIT capitalisations above underlying asset values.

Overvaluation, combined with the 1998 Asian financial crisis and the hi-tech stock market boom, temporarily took the shine off the REIT market. But, more recently, a benign interest rate environment and the switch of investor interest to property following the bursting of the hi-tech bubble has revived REIT shares and turned them into a growth stock once again.[16]

Recent experience in the USA shows that the REIT market there has been subject to notable volatility, arising from swings in market circumstances and investor sentiment, though it should be noted that more of the fluctuations have been borne in share valuations than in underlying REIT property asset holdings.

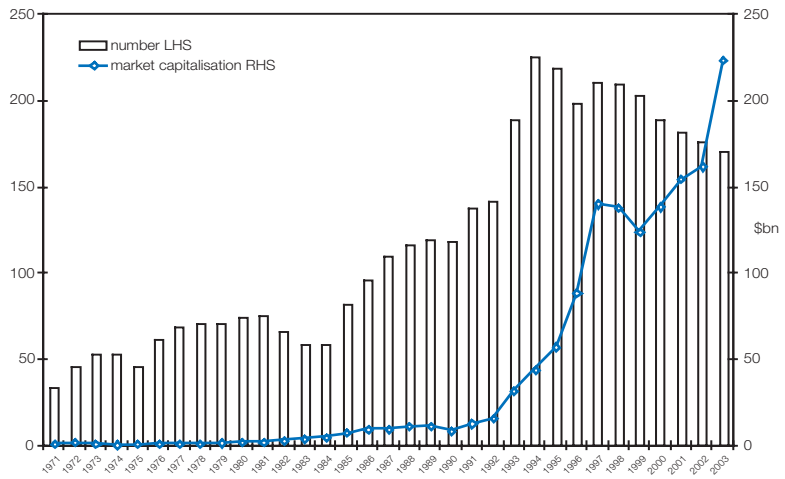
To an extent, it can be concluded that recent REIT growth in the USA and other countries has been cyclical and associated with variations over time in the expected total returns of particular types of asset. Yet, the new scale of REITs in US investors' portfolios indicates that there has also been a permanent change in asset class holdings. The modern US REIT market, being only somewhat over a decade old, is still too recent to be able to make firm predictions about its long-term behaviour.

The limitations of REITs

The potential benefits of REITs should not be under-estimated in improving property market functioning through increasing liquidity, transparency and competition for investor funds. Nonetheless, there are drawbacks to the REIT framework. The principal difficulties, as far as the property market is concerned, relate to the rigidity of the REIT structure. This means that it is not appropriate for all market circumstances and organisations.

The fact that REITs specialise in a narrow range of property types, for example, leaves them exposed when the market in those assets turns down, with no cushion available from a more diversified asset structure. Within any property type, furthermore, to sustain shareholder interest and ensure transparency of asset holdings, prime, modern, standardised properties are likely to prevail in REIT portfolios, which again narrows the potential

Figure 4.2 *US REITs number and capitalisation 1971-2003*



Source NAREIT

benefits of portfolio diversification. This helps to explain potential REIT share volatility.

The requirement inherent in the notion of 'passive' investment to separate development from asset ownership can also limit the property returns available to investors. More risky, but higher return, property activities cannot be undertaken by REITs. Like their underlying assets, therefore, they are a low risk, low return type of stock over the long-term that may disappoint many hoping to see substantial long-term financial gains from the introduction of the REIT model into the UK.

REITs by being passive investment vehicles have limited opportunities to influence the revenue earning characteristics of the properties they own. Upgrading property portfolios, or changing the mix of uses in a development to reflect changing patterns of demand, overstretches the notion of passive management, because such actions are clearly active portfolio management.

The UPREIT and DOWNREIT formats were introduced in the USA in order to make it possible for REITs to work with partners in the development pipeline. Even so, in the USA, REITs are always chafing at the constraints imposed on their activities, which strongly require them to be passive property investors in order to qualify as a quasi-pass-through entity that should not be subject to corporation tax.

Residential REITs

Of particular concern to the privately rented sector, of course, is the development of residential PIFs. The general arguments for REITs outlined above in terms of market liquidity and efficiency hold for residential as much as for any other property sector and so do not need to be considered again, though it should be emphasised that they are as important in the residential sector as in other classes of property. Even so, three specific issues do take on particular importance in the residential sector. These are:

1 What type of market segment would residential PIFs invest in and with what results?

2 If PIFs were successful, what would be the effects on the size of the privately rented sector and its relationship to other housing tenures?

3 Can any special cases for PIFs be justified in the housing sphere?

Residential PIFs in the current housing environment

The experience of the USA, the most mature of the REIT markets, is illustrative of the likely impact of PIFs in the UK privately rented sector. This can be studied by looking at the size and characteristics of the 21, stock exchange quoted, US residential REITs.[17]

The total market capitalisation of such residential REITs in the USA is $34 billion. Though a significant sum, this is less than one per cent of the total value of the US privately rented housing stock.[18] This obviously implies that residential REITs have had a limited impact on the privately rented sector in the USA. Small-scale private landlords still predominate, as they do here and in virtually all countries' privately rented sectors.

Yet, it could be argued that the impact of US Residential REITs has still been substantial in some localities, because REIT activity is concentrated in certain growth regions. Furthermore, the sector has only really been active for a little over a decade, which in property terms is still early days. The impact may consequently be greater over the long-term.

Other characteristics of US residential REITs are illustrative of what might happen here. They specialise in the middle-to-upper parts of the privately rented sector and invest in large-blocks of new property. They often invest in partner-developer built large suburban apartment communities (via the UPREIT format). Older properties and piecemeal property holdings imply high transactions costs and a lack of transparency in asset holdings and so do not form part of US residential REIT portfolios.

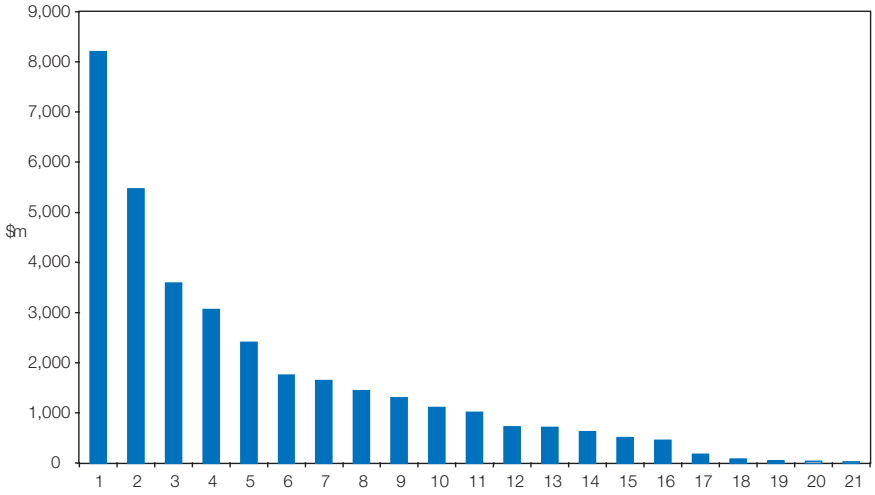
There are interesting size characteristics as well. The largest US residential REITs have a major share of the total market capitalisation of the sector. This can be seen in Figure 4.3, where US REITs are listed sequentially by market capitalisation. The largest one represents almost a quarter of the sector's total market capitalisation and the top three alone constitute half of it. This suggests that there are considerable economies of scale for residential REITs in contrast to other types of landlord, probably associated with their ability to raise capital.

The US experience, consequently, does not suggest that a dramatic transformation of the privately rented sector is going to happen as a result of the introduction of PIFs into the UK, particularly in the short-run. This also means that the impact on other housing tenures is likely to be small. In addition, in the absence of other incentives, they may operate primarily in an area of the privately rented sector that is already well-served by small landlords – though how direct the competition would be is unclear as REITs could not feasibly invest in the older stock that individual landlords typically specialise in.

Caution on the limited impact of PIFs is also signalled by the earlier failure of Housing Investment Trusts (HITs). These were a securitised vehicle introduced in 1996 that were to offer lower corporation and capital gains tax in order to encourage City institutions to invest in residential property. Yet no HIT has been launched – partly because of a reluctance to invest in residential and because of concomitant tax changes that weakened the attractiveness of the HIT model.[19] However, the HIT vehicle is not fully tax-transparent unlike PIFs. There is also the benefit of a broader PIF market than was ever likely for HITs as other forms of commercial property are likely to be packaged into the PIF framework as well as housing.

This somewhat downbeat view derived from the US residential REIT and UK HIT experience does not mean that there are no potential benefits to be derived from the REIT/PIF model in the UK. Two other features of the US experience are apposite here. Namely, their focus on new properties and the ability of some REITs to mobilise large sums of capital into the provision of privately rented housing.

Figure 4.3 *US Residential REITs by market capitalisation 2004**



*Numbers on the x-axis list the largest quoted residential REIT as 1 through to the smallest as 21.
Source NAREIT

The Interim Barker Report identified a reluctance of housing developers to build high density, high rise private developments.[20] The PIF approach could, therefore, help to overcome this reluctance and generate additional new housing output for the privately rented sector. This would benefit housing affordability overall by increasing housing supply in areas of high demand. PIFs may also build such structures in niche rental markets, such as that for student housing. As the demand for private renting tends to be especially strong in inner city locations, furthermore, such built forms would encourage brownfield housing development/redevelopment – another target of current government policy.

Residential PIFs, more generally, could play an important role in urban regeneration by building apartment blocks for renters in such areas. In locations, such as the Thames Gateway area to the east of London, the PIF format could have a substantial impact and greatly increase the likelihood of a significant number of privately rented properties being made available.

An issue arises in urban regeneration areas, however, in that building rental apartments in those localities may be of a higher risk than is acceptable to typical REIT investors. This may mean that for the residential PIF model to operate in such contexts their returns might have to be higher to compensate for the additional risk and that some form of income guarantee or building subsidy may be necessary. It may well be the case, however, that the PIF format is a good way for public subsidies to be used to leverage large amounts of private investment into socially desirable housing schemes.

Expanding the privately rented sector into social housing spheres

Residential PIFs could also be used to acquire newly built privately rented housing in market areas more traditionally associated with social housing, including some of the more recent initiatives for 'cost-rented' housing provision. Similarly, some existing social housing – much of which has high refurbishment costs associated with it – could be improved and sold off to REITs for future private renting. Belgian experience offers a useful precedent, because recently the Belgian government announced plans to set up a specialised REIT to provide funds and expertise to bring the country's dilapidated social housing stock up to modern standards.[21]

REITs would also have another advantage over more traditional forms of social housing and the

private finance initiatives associated with it. They would provide more transparent public information in terms of costs and returns, because investors in PIF shares would demand such information to be public knowledge. This information would then be useful for bench-marking social housing institutions' performance.

It is probably unwise, nevertheless, to use the REIT format to perpetuate non-market rents or heavily housing benefit subsidised rents, because that would make such REIT/PIF investments highly dependent on the continuation of such subsidies.

1 Data in this section are drawn from the *English House Condition Survey's Landlords' Survey* 2001/2, ODPM.

2 Extrapolating to 2004 from the data in Table 4.1.

3 The value of holdings would be a better indicator of investor commitment than the number of properties owned, because one expensive property could easily be worth several cheaper ones.

4 Crook, ADH and PA Kemp (1996) 'The revival of private rented housing in Britain'. *Housing Studies*. The latest data using these categories are in the *English House Condition Survey's Landlords' Survey* 2001/2, ODPM.

5 This conclusion is based on the fact that small landlords have always predominated in any country's privately rented sector. Actual detailed cost studies of economies of scale unfortunately do not exist. One reason for low scale economies is that large organisations can suffer a division of interest between principals (property owners) and agents (managers), may develop inflexible bureaucratic structures (which is particularly problematic in the shifting terrain of housing provision) and other types of inefficiency ('cultures', etc. – often called X-inefficiencies). These characteristics, for example, help to explain inefficiencies amongst larger social landlords.

6 Small landlords prepared to undertake all management and repair tasks themselves obviously pay no VAT on those services, unlike those that use professionals.

7 These issues are discussed in greater detail in Crook, ADH and PA Kemp (1999) 'Financial institutions and private rented housing'. York, York Publishing Services for the Joseph Rowntree Foundation.

8 Some international evidence of such changes is reported in *The Private Rented Sector and Institutional Investment: Lessons From Overseas* A.D.H.Crook, Joseph Rowntree Foundation, 2000.

9 Survey of English Housing 2001/2.

10 Mortgages lenders, as noted earlier, currently treat this level as being met by a combination of loan-to-property value and net-rental-income to mortgage outgoings ratios.

11 Pension funds, for example, had 15% of their portfolios in commercial property in the early 1980s and only 4% in the late 1990s.

12 See the Investment Property Forum website: www.ipf.org.uk.

13 In the USA, they are allowed to go into partnership with others that undertake such activities in the UPREIT and DOWNREIT formats.

14 Conversely, they can write off any losses against their capital gains on other investments – though, once again, the precise rules vary from country to country.

15 See Ball, M., Lizieri, C., Macgregor, B. *The Economics of Commercial Property Markets* where there is also an extensive theoretical and empirical discussion of property investment and finance issues.

16 Thanks to Peter Brady for some helpful information on US REITs. See Brady, Peter J. 1998. "A Look at the Resurgence of REITs." Mimeo. Federal Reserve Board of Governors, Washington, DC. January 1998. No responsibility for any factual errors or commentary on the US situation here lies with him.

17 Source: NAREIT.

18 A UPE Consultancy estimate.

19 ADH Crook et al. 2002 *Investment returns in the private rented housing sector*, British Property Federation, London.

20 *Review of Housing Supply. Interim report – Analysis*. K. Barker, UK Treasury, London, 2003.

21 See the Urban Land Institute's web site: www.uli.org.

CHAPTER FIVE

Quality regulation: The re-introduction of Government control

Introduction

Concerns about measured standards of housing quality and safety in the privately rented sector have grown over the past decade. A significant segment of poor condition housing is argued to exist. The consensus view, without doubt, is that all houses should be fully repaired and meet strict officially laid down quality and safety criteria. To achieve this, action is needed beyond the requirements of existing legislation on repairs and standards that can currently be enforced through the courts.[1]

Though the government has resisted the more draconian arguments for regulatory measures to date, it has still accepted some, which are now passing through Parliament in the current Housing Bill. Claims about standards in the privately rented sector, therefore, are leading to re-regulation in the privately rented sector. Is a brief era of a loosening of government control over private renting coming to an end?

The most extensive area of new compulsion relates to the mandatory licensing of houses in multiple occupation (HMOs). The ones now to be licensed in England are multiple dwelling structures of three or more storeys containing five or more residents. Compulsory HMO licensing has already been introduced in Scotland and Northern Ireland and has recently become law in England.

These pieces of legislation criminalise any landlord that does not register with the local authority as a landlord of an HMO and undertake the appropriate actions associated with being registered. Such actions will include, amongst other things, bringing dwellings up to the appropriate defined standards, demonstrating capabilities in housing management and funding, and playing a part in tackling the anti-social behaviour of tenants. There will also be compulsory registration for landlords in areas of low housing demand – as defined by the local authority – and for other 'selective groups'. In Scotland, licensing has been associated with compulsory fees imposed on landlords to fund the scheme, which has caused unprecedented resentment amongst the landlord community.

These requirements, furthermore, are being imposed on the privately rented sector alone, as the legislation applies neither to social housing nor to owner occupation. If a group of students rented separate tenancy bed-sit rooms with some common facilities in a three storey building from a landlord that structure would thus be subject to the licensing rules. If they bought an equivalent house on a joint basis and lived in it in the same way as joint homeowners, licensing would not be an issue. Yet, the living circumstances and the risks associated with them are presumably similar. The legislation is consequently discriminatory, because the privately rented sector is identified specifically as a problem area. The response from supporters of the current legislation is that people need more protection from the actions of private landlords and other private tenants than they do from other members of their own households. The exclusion of social housing is presumably on the basis that social landlords are more responsible and better able to deal with potential inter-tenant difficulties. Both these arguments may seem contentious to many, so that the discrimination charge still has merit.

It is not the purpose of this chapter to go through every aspect of recent attempts at the re-regulation of the privately rented sector.

Instead, this chapter will question a sole reliance on regulation to improve the privately rented sector and also the use of external 'engineering' standards as the only true theory and identifier of the optimal level of housing quality. It will also highlight some unintended consequences that may arise as a result of adopting such strategies.

A fundamental point is being made. Contrary to what had been literally centuries of interventionist ascendancy, most housing lobbies and commentators have over the past decade embraced free market mechanisms as being the only means of ensuring that the privately rented sector will survive as a viable and vibrant part of the UK housing scene.[2] They still seem to accept that principle broadly with respect to the price of rental accommodation. Yet many housing commentators, and the government, are now beginning to reject free market principles in terms of the setting of housing standards or quality. Housing quality is part of the quantity of rental housing provided, in that a lower quality means that a smaller overall quantity of housing services is being provided by a specific dwelling unit. Controlling quantities in a market is as much an interference with free market processes as controlling prices and should, therefore, not be done unless absolutely necessary.

The issue of quantity regulation is complex, because there are several means by which it can be conducted and the empirical effects of each of them can be interpreted in several ways. Regulation includes both legislation and the degree to which it enforced in practice. As the laws clock up in number, it may seem paradoxical that the number of enforcement orders carried out on private landlords has actually fallen in recent years. This may suggest less regulation in practice, a softer touch, or it could indicate the opposite, a harder touch with more effective enforcement of the law, which discourages the undesired behaviour and, therefore, leads to a lower incidence of the event. Alternatively, less actual enforcement could result from factors entirely unrelated to the legislation itself. The growth of a free rental market over the past years, for example, has been associated with more tenants on average who can afford higher rents and want good quality accommodation at the same time as greater competition between landlords has encouraged them to provide that mix.

Regulation may also have weaker forms than direct coercion and criminalisation. For instance, discretionary improvement grants have been switched from owner occupation to the privately rented sector. This is an incentive form of regulation, because the promise of cash to raise their rental incomes and lower their costs encourages landlords to behave in the ways required by the gatekeepers of those discretionary grants.

Whatever the means of regulation, the point is the same. The various tiers of government wish to steer private landlords into delivering housing of a particular type quality-wise. The two key issues are: 1. are the directions the right ones, taking into account any indirect or second-round effects that may occur? 2. Even if the outcomes are desirable, are the powers and the implementing agencies any good at achieving them? Principle and practice are intertwined and policy may fail on either count.

The issues focused on here relate to housing conditions and the thrust of the 'Housing Bill' legislation that recently passed its third reading in the Commons. Arguments such as the ones being made here are often misunderstood as being hard-hearted, because concerns about housing conditions in the privately rented sector primarily relate to health and safety issues. People should never be exposed to health and safety risks, many would believe. It is important to stress that it is not the intention of the argument being made here that people should be exposed to unreasonable risks, rather that the heart has to be led by the head in a policy context.

The argument is that risk and health prevention measures have costs as well as benefits and that the costs can easily outweigh the benefits. No full cost-benefit calculation to the author's knowledge has ever been undertaken when setting out house safety or condition measures nor in setting minimum housing requirements. The world is full of risks. It costs resources and closes off consumption possibilities to limit them, which are reasons why no-one opts for a zero risk life. Why should housing be any different?

Furthermore, the mere existence of regulation does not make problems go away. That obvious fact can be illustrated simply by noting that crimes still continue despite extensive laws and crime prevention measures. Why should housing regulation necessarily be effective? It, after all, has not been an unqualified success in the past.

Safety and housing

Safety issues with housing are important. There were around 4,000 deaths related to home place events in 1998, for example, more than either traffic or work-related ones.[3] Improving safety is clearly a good idea, but the benefits have to outweigh the costs. If this decision rule is used, the case for additional legislation may be strong. There is a worrying concern, however, that it is not being adopted in much policy debate over the privately rented sector.

In calculating the likely cost-benefit ratio of safety regulation, four factors have to be brought into consideration that do not seem to occur at present.

1 In order to calculate the benefits, a theory of cause and effect must be proposed, empirical outcomes estimated and an aggregate value put on the lives saved or injuries avoided by undertaking specific actions. Both the theory and results need to be subject to scrutiny. Simple broad-brush correlations are not enough, because that might mis-specify causes and lead to wasted actions and expense. Yet, such correlations seem to be the basis for much current housing quality and safety commentary. The case for intervention is primarily based on statistical evidence concerning the incidence of accidents and fires in particular dwelling types, instead of on the causes of those events and how they and their consequences can be limited.[4]

2 Full costs have to be calculated. Importantly, they should include spillover effects. For example, raising the costs of providing one type of housing may make it less profitable to provide, so that supply falls and rents rise. Some current or potential tenants, therefore, may have to choose worse and more risky housing options.

3 An important cost consideration is that the general impact of regulatory uncertainty may lower investment throughout the privately rented sector. Introducing regulations in one part of the privately rented sector may worry investors in other segments that governments cannot be trusted to let free markets operate. The risk of regulatory threat may then deter investors, thereby restricting supply and raising rents throughout the market-based privately rented sector.

4 It cannot be assumed that regulatory intervention will necessarily work, so any potential benefits may need to be heavily discounted to derive a realistic benefit assessment. With regard to HMOs, for example, the Housing (Fire Safety in Houses in Multiple Occupation) Order of 1997 had already placed an additional duty on local authorities to ensure that fire safety measures were adequate in HMOs of three storeys or above. Yet, the current Housing Bill legislation has by implication deemed that earlier measure to be ineffective. What is the evidence that the proposed measures will do any better? With limited monitoring resources, for instance, it may be difficult to

ensure licensed premises are run in the appropriate manner.

Moreover, raising the hurdle for being a legitimate HMO landlord may encourage the unscrupulous to be illegal ones. To say that they would be punished by fines when caught and could not pursue tenants through the courts for non-payment of rent may be weak deterrents. Criminals (which such landlords would be) generally have other means of encouraging payment and stopping informants. This is another risk of regulation: putting things beyond the law can encourage the existence of some appalling housing situations.

Dwelling condition and repairs: engineering versus economic approaches

According to the English House Condition Survey 2001, the privately rented sector disproportionately has more cases of unfitness and disrepair than the housing stock as a whole. Ten per cent was classified as unfit in 2001, half did not meet the decent homes standard and more than a fifth required more than £10,000 worth of repairs – with 14% in need of £5,000 or more urgent repairs.

Though there has been some improvement in the average numbers in recent years with the letting of better quality dwellings as a result of the growth of the market-rented sector, these data suggest that there are significant problems with repairs in the privately rented sector. Should this be a matter of general concern with the operation of the privately rented sector?

There are several issues of interest here:

1 Concentration of disrepair in certain parts of the privately rented sector

The privately rented sector was argued in Chapter 2 to consist of a series of segmented markets, so it may be inappropriate to average disrepair across all parts of it. Disrepair is likely to be disproportionately concentrated in particular market segments, particularly the cheaper and low demand area parts.

2 Is there an optimal level of repair?

The measurements in the English House Condition Survey are based on a pre-defined set of physical standards. Fully repaired is when the repair criteria are all met. Fitness exists when the fitness ones are passed. The same occurs with decent standards and so on. These measures are devised by well-meaning committees, but many lay-people would find certain elements of them arbitrary and unnecessary. The standards are also all embracing, whereas some dwellings may be fit for some people's housing circumstances but not others. The generalist approach will be furthered with the introduction of the Housing Health and Safety Rating System[5] in the 2004 Housing Bill, which will replace the unfitness and repair standards with a broader set of measurements identifying problems with quality aspects of the privately rented sector and will be given a prominent place in the next English House Condition Survey.

On the basis of such pre-defined standards and using trained professional eyes, detailed housing surveys are undertaken. The final aggregate numbers on standards and repair levels are then estimated by extrapolating from those sample surveys. Here, this will be called the engineering approach.

An economic definition of fully repaired would take a somewhat different tack. A building is optimally repaired when the marginal benefits of doing so equal the marginal costs of repairing and maintaining a structure to a particular standard. That standard may well be lower than the engineering standard, because keeping a house fully repaired in engineering terms may simply not be worth it. Disrepair in economic terms, therefore, may not actually be a social bad but actually a social good, because it shows that resources are not being unnecessarily wasted on excessively high building standards and, so, can be put to better social uses.

3 Private renting or older properties?

Chapter 2 highlighted the fact that privately rented dwellings are often in old properties, far more so than in other tenures, and that these properties tend to be inner city ones, rather than 'chocolate box' ancient gems lovingly restored and preserved by their owners. This profile may help to explain part of the higher repair needs in the privately rented sector.

4 Market outcomes lead to variations in building quality

Rational responses to housing affordability problems may be for tenants to accept lower quality housing and for landlords to supply it. A lower quality for a lower price is a common feature of many markets and housing is no exception. Low price-low quality outcomes may be particularly appropriate for some tenants, because many of them will move on again within a short period of time. Living in a lower quality dwelling for a limited period may help some people afford a better home later on or make it possible to move into a locality at a low transaction cost and subsequently search for a better dwelling.

To impose high minimum standards in housing, consequently, is to close off housing supply and housing options for people. Housing standards may be raised in this way, which looks good in house condition surveys, but it also leads to higher rents and less overall housing in existence. Moreover, if housing standards were a moving target, with the rules ratcheted up every time an average improvement was recorded or a housing-related tragedy occurred, this would generate general investor fears that repair and improvement bills might be raised even higher. By creating broad uncertainty, the negative impact on landlord investment could be great.

At the end of such a process, a small, though pristine, privately rented housing stock would be left. The economic and social cost of such an outcome would be unfortunate and enormous – and everyone would wonder where all the housing went.

5 The importance of market-based theory

Quality control, in other words, has a similar impact to rent control, particularly over the long-term, in that it can lead to a drastic reduction in the amount of rental housing supplied. The resultant limited supply would create shortages and raise general rent levels. The paradox, therefore, arises of costs being borne in higher rents by those tenants whose landlords already provide high quality accommodation. General housing affordability would also worsen.

Such second round implications of trying to control housing quality are rarely brought into discussions about the issue. However, such effects are vital to an understanding of the full impact of quality regulation.

A similar point could be made about improving security of tenure, which is sometimes proposed for the privately rented sector. Stricter security of tenure rules would raise costs for all landlords, which would lower supply and, thereby, increase rents. All tenants would lose out from the higher rent charges and only a few would actually benefit from the extra security – and many of them would be quite well-off and not in particular need of such a measure anyway. It would be highly unlikely that the overall beneficiaries would be the low income and the homeless. More probable would be that such groups would be some of the worst affected.

Economic theory, thus, has the advantage of looking at the wider ramifications of housing market interventions and the feedback effects that they create. Though often regarded as an approach that is dismissive of social impacts, it can often identify the true social consequences of events which much housing policy commentary tends to gloss over or ignore.

It is particularly noticeable with respect to housing repair issues that the economic approach has been almost universally ignored. More commonplace is a theory that puts emphasis on a moralistic behavioural distinction

between types of landlord, which can be dubbed the theory of the good, the bad and the ignorant.

This theory assumes that there are 'good' landlords that automatically repair up to the best engineering standards, simply because they are good. In contrast, 'bad' landlords deliberately do not repair in order to make more money. In between are the 'fallen angels': the ignorant ones that would be good if they knew how to, but know nothing about repairs.

This faulty theory amazingly is promoted in official government documents. For example, it underlies the commentary in the English House Condition Survey 2001 Landlords Survey. That survey report includes, for example, the following observation: '...more commercially oriented owners of poor condition properties who could be described as 'milking' them for rental income'. Landlords that turn into milkmaids are clearly to be regarded as bad, yet that interpretation hardly counts as unbiased factual reporting of house conditions.

An economic analysis brings out the weakness of such interpretations of the causes of housing quality. Of limited relevance in it are matters like landlords' knowledge of building science; whether they have found an honest, local builder; or whether landlords are good or bad people. Rather, the conclusion would be that housing standards lie on a continuum that is determined in particular locations by the cost of providing buildings of specific quality levels there and tenants' relative willingness to pay for them.

Three views of housing repairs: which is right?

The levels of disrepair reported by building surveyors are much higher than the views of either landlords and tenants. This may be due to physical factors – not all building problems may affect the actual living accommodation of tenants, for instance. Or it may be due to ignorance, a landlord unskilled in building matters might mistake a serious repair problem for a minor one.

All the same, some of the reported differences between the three views may be identifying a difference between engineering standards and cost-benefit repair optimisation processes. The views of landlords and tenants over repairs certainly should not be discounted. They after all are the ones that strike bargains over price and quality in the privately rented sector.

When interpreting survey results, because of the nature of the landlord-tenant relationship it is to be expected that landlords are likely to give overly positive views about events associated with themselves and that tenants are likely to have overly-negative views about landlord behaviour. So, perhaps, the truth may lie somewhere in the middle.

Combining the results of the Survey of English Housing and the English House Condition Survey, the following views on housing repairs can be found. Only 3% of landlords and agents say there are serious repair problems. In contrast, 22% private tenants say repairs are needed, but only 10% of them are actually dissatisfied with repairs. Moreover, only 5% of private tenants are very dissatisfied with their landlord overall.

These data suggest a ball park figure for the consensus view of repair problems in the privately rented sector on the part of landlords and tenants. The difference between tenants' views about repairs being needed and their level of dissatisfaction with the repairs service may be due to a pipeline effect. That is, things have not been fixed yet, but they expect it to happen soon. In the same vein, if repairs were a major issue, it would be expected that tenants would be very dissatisfied with their landlord, though only 5% say they actually are. The differences in landlord and tenant views, therefore, are not that great – especially in relation to the much higher figures reported in house condition surveys.

The juxtaposition of these results, therefore, highlights a massive difference between landlord and tenant views, on the one hand, and house condition survey results, on the other hand. This suggests that repair problems in the privately rented sector are not as great as they may seem to be. It certainly does not indicate the need for widespread regulation to raise housing quality standards throughout the tenure.

This is not to say that issues like landlord ignorance and the difficulty of finding decent repair and maintenance builders are unimportant. Rather it is to put such factors into perspective. Some improvement in housing quality standards may result from better landlord knowledge or easier means of dealing with good quality building services, but the privately rented sector is not uniquely afflicted by such features. They do not, for instance, differentiate the privately rented sector from similar problems in owner occupation and, so, do not represent convincing candidates to explain why measured repair levels seem to be so much worse in the privately rented sector.

Narrowing the costs of good and lower quality housing through tax reform

It was argued above that quality differences primarily arise because of differences in the cost of providing housing of distinct quality levels and variations in households' willingness to pay for them. On the supply side, the difference in the supply cost between better and worse quality is determined, first, by the relative building costs associated with different states of repair and, second, by the scale and costs of periodic improvements and modernisations to dwelling facilities.

In the UK, both housing repair and improvement costs are subject to VAT taxation. Housing rents are not subject to VAT, so that many landlords are not registered for VAT, as they have little or no VAT liability. This means that most cannot claim back the VAT imposed on repairs. It is also impossible to reclaim VAT on improvements in all cases, because they are not deemed to be necessary business costs. In addition, expenditure on building improvement works cannot be depreciated in the UK and offset against tax liabilities. These tax effects, consequently, create an undesirably large wedge between the cost of maintaining housing at lower and higher quality levels.

The UK tax system with respect to the privately rented sector, therefore, must bear some responsibility for lower than desired housing quality standards. It seems particularly ironic that one part of government is exacerbating housing quality problems through the tax system, while another is trying to improve them through extensive and expensive measurement and regulation schemes and large expenditures on urban renewal programmes. The case for lower taxation on repairs and improvements seems strong.

Some countries allow substantial depreciation allowances for landlords of rental property: notably, Germany, France, Australia and New Zealand. Though not necessarily ideal tax breaks, these general depreciation allowances do have a positive impact on housing quality standards in the privately rented sector by giving landlords an incentive to keep their property at a high standard. The size of the depreciation allowance is determined by the value of the property owned. As housing quality is an influence on the value of a dwelling, these depreciation allowances therefore encourage landlords to keep up the quality of their properties. The depreciation allowance, in other words, lowers considerably the net cost difference between owning a good and lower quality dwelling in favour of the better quality one.

The supply route to improved rental housing quality

Another way to improve privately rented housing quality is to increase the overall supply

of housing, because that creates greater choice in a housing market. Landlords would then have to compete more fiercely to attract tenants and those with poorer quality dwellings would find it less easy to attract tenants.

Extra housing supply not only reduces the general price of housing, but also lowers the price differential between houses of different quality. This makes it cheaper for landlords to offer a better product as the cost differential between a good and lower quality dwelling narrows.

In summary, increasing housing supply induces greater competition and lowers price differentials. It, therefore, is one of the best remedies for poor quality housing as it drives out the worse and raises standards. Regulation of quality does the opposite. It reduces housing supply and thereby lowers landlord competition and raises the cost differential between providing good and poor quality housing. Regulation paradoxically can actually worsen overall housing quality rather than improve it.[6]

Two exceptions

The arguments above have assumed that markets work, which is mainly the case in the British housing system when they are allowed to. Yet, there are two situations where markets do not seem to work well: areas of low housing demand and privately rented housing that is associated with housing benefit.

Low demand

In areas of low housing demand, common in many northern cities, housing supply is seemingly plentiful but, in fact, it is not. Neighbourhood and dwelling quality problems make the overall housing supply package shrink to insignificance. Low demand, therefore, is associated with low, quality adjusted, supply. In market terms, the housing is worthless – though the land on which it stands is probably not – so demolition is usually the best answer. Policy makers and commentators, however, often baulk at what they see as the waste of demolishing 'good' housing. In fact, the waste more likely is in spending money to retain what is not wanted.

Areas of low demand, in addition, probably distort the aggregate privately rented sector repair statistics, which include such housing. The housing in such localities may be classified as private rental property, even when no-one wants it, and will generally be in a poor condition.

Housing benefit

Housing benefit in the privately rented sector may lock tenants into particular housing, particularly when the rent is paid directly to the landlord. The bargaining position of the tenant as a result may be weak and the landlord may consequently lower the quality of the housing provided below that normal for the rent level, as they know the tenant cannot move easily.

This situation may well arise in practice. But, as was argued in Chapter 3, the housing benefit part of the privately rented sector is not a true market but one controlled by housing benefit rules. As such the criticism is of those rules rather than the rental market itself. Such weak tenants' positions certainly suggest that the movement towards housing vouchers might improve housing benefit tenants' negotiating power. Furthermore, there seems to be an onus on benefit providers to make periodic random visits to their clients' dwellings to ensure that contractual conditions are being honoured.

1 They include the Housing and Landlord and Tenant Acts 1985 and the Defective Premises Act 1972.

2 Housing policy textbooks, even as late as the mid-1990s, were dismissive or pessimistic about the likely success of the 1989 deregulation measures. See, for example, P. Balchin, *Housing Policy* 1995 and J. Hills ed. *The State of Welfare* 1994.

3 *Home and Leisure Accident Report. Summary of 1998 data*, Department of Trade and Industry, London, 2000.

4 The housing provision aspects of fire accidents, for instance, have been linked to a low proportion of fatalities in HMOs, see N. Cowell, *An Analysis of Fire Fatalities in Houses of Multiple Occupation 1996-2003*, National Landlords Association, 2003.

5 See ODPM website, www.odpm.gov.uk, and "The Housing Health and Safety Rating System – a new method of assessing housing standards reviewed", J. Stewart, *Journal of Environmental Health Research*, Volume 2, Issue 1, July 2003.

6 A corollary of this argument is that the UK has a poorer quality housing stock than some of its European neighbours because housing supply is more limited here than in those countries.

CHAPTER SIX

Returns and taxation

Introduction

This chapter examines the interrelated issues of residential investor returns and taxation. If landlords cannot generate long run risk-adjusted returns that are at least as good as those that can be earned by investing in other assets, they will not invest in the privately rented sector. Similarly, if tax breaks and subsidies are more attractive in other tenures, potential tenants will choose to live in them – if they can. Returns and taxation are consequently central to the future of privately rented housing.

This chapter points out that landlords face a number of unique running costs that do not exist in owner occupation. As a result, rents have to be higher than equivalent owner occupation costs in order that landlords can earn a competitive return. This is one of the main reasons why homeownership is a more attractive tenure for many households. This suggests that the privately rented sector cannot be expected to increase significantly at the expense of owner occupation, even when tax regimes are neutral in their impact on one tenure or another.

Traditionally, the tax breaks offered to owner occupation in the UK were much more attractive than those available in the privately rented sector, but over the last decade that has changed significantly. The current tax position of these two tenures is investigated below, as part of a general discussion of taxation and the privately rented sector. Some reforms to the tax regime in the privately rented sector are suggested.

There is not a detailed discussion of the relationship between taxes and subsidies in private renting and social housing, because the issues have been considered in earlier chapters. In general, however, the subsidies and tax breaks existing in the social rented sector mean that most low income tenants only live in the privately rented sector if they cannot get decent social housing in the neighbourhood where they want to live.

Higher running costs in the privately rented sector

Landlords face a variety of annual costs, apart from those associated with servicing loans and the opportunity cost of their own capital.

One of the greatest influences on net rental income after running costs is the prospect of having no tenant (a void) for significant periods of time.[1] Average voids have recently been running at about a month a year for dwellings in market renting.[2] This average vacancy period is partly determined by the current balance between demand and supply, but to a great extent reflects the mobility of tenants and the associated churn of tenancies. Landlords cannot instantly match their dwellings with a new tenant when a previous one leaves and, therefore, have to accept times when their properties are empty. Mobility in the privately rented sector has a hidden cost, in other words, in the form of vacant periods when no-one lives in such dwellings, which seems currently in the free market sector to be around 8% of the time a rental dwelling is in existence.

Non-payment of rent is another factor, either in the form of arrears or bad debts from tenants that have left without paying all of the rent. In addition, there are costs associated with agency fees, or other charges for finding new tenants, plus on-going property management fees and other costs such as keeping accounts. The wear-and-tear on soft furnishings, equipment and

internal decoration has also to be taken into account. Table 6.1 shows a variety of other costs. Altogether these costs typically account for 30 to 60% of gross potential rents.[3]

Such high running costs help to explain why private landlords are keen to keep good tenants. A long let to people that minimise wear-and-tear costs and promptly pay their rent leads to far lower costs.

***Table 6.1** Non-capital residential letting costs*

Voids*
Bad debts*
Net arrears*
Letting fees*
Property management fees*
Service charges†
Ground rent†
Building insurance
Contents insurance
Maintenance
Repairs (minor)**
Replacement/repair soft furnishings and contents**

*renting only †flats only **higher in renting

These running costs also show why investors in residential property need far higher gross returns on rents than do investors in commercial property. Commercial property does not lead to such high management costs, because the risks associated with rent arrears, bad behaviour and high tenant turnover are far less. Commercial leasing contracts are also structured to induce particular forms of tenant behaviour, such as limited turnover. They lead to an apportionment of risks away from landlord to the tenant in contrast to the residential sector – as occurs with commercial long leases and upward only rent reviews. Such contracts are generally unfeasible in residential letting. Commercial landlords can therefore operate at far lower gross margins than residential ones.

Landlords' running costs also help to demonstrate why from a household's point of view renting typically is significantly more expensive than home ownership. Homeowners are both their own landlord and tenant, by definition, and so face no voids nor arrears. Their property management costs are noticeably less, because they do not have to deal with high tenant turnover. Finally, wear-and-tear costs are likely to be lower for owner occupiers, because they are reduced by the incentives of looking after your own property. The extra costs borne by landlords consequently have to be reflected in the rents they charge for an equivalent property to an owner occupied one in addition to the similar pre-tax capital costs of house purchase, structural maintenance and repair in either tenure.

Such extra running costs for landlords are substantial, as already noted, and, in the main, constitute the economic deadweight cost of private renting. They are deadweight in that those costs would not exist if housing were lived in a different form (i.e. as owner occupation).[4]

One way of looking at these cost differences in the aggregate is to recognise that owner occupation confers significant economies over renting as a form of managing the existing housing stock and peoples' housing circumstances. Those cost differences are generally not included in housing user cost of capital comparisons between renting and owning, but help to explain the growth of owner occupation.

Net rental returns

Having taken account of their running costs, landlords' returns consist of net rental income plus any capital gains minus taxes. There is much talk about whether current net returns in the privately rented sector are sufficient to sustain it over the long-term. A significant contributor to residential returns has been capital growth in recent years, with house prices rising well above trend levels. Such capital gain returns, of course, cannot continue forever. So, it could be argued that landlords are likely to face lower returns in the future, leading to many quitting the sector.

This may not be such an important issue for the current size of the privately rented sector as is supposed, because total returns currently are probably well above their long-run equilibrium level, particularly for geared investments. The impact of gearing on residential investor returns can be seen in the ARLA returns data for the end of 2003.[5] The total return for a cash residential investor was 11-12%, but for one that borrowed 75% of the initial capital costs through a mortgage, the return was double that. These returns are very high for what is normally classified as a relatively low risk, safe investment class. A decline in returns from such levels should not lead to massive retrenchment, especially if more residential investors take advantage of gearing possibilities.

Taxation and its consequences

Tax distortions

Most taxes are non-neutral in the sense that governments by imposing taxes distort the markets from which they collect their revenue. Subsidies can have similar effects by altering relative production costs or the prices of various consumption possibilities. Taxation and subsidy have long been known to distort activity to a particularly large extent in the housing market and, because housing is such a large element in personal expenditure, such distortions have widespread economic and social impacts.

Government fiscal policy distorts housing provision in two ways. First, by encouraging expenditure on housing in relation to other activities. Second, by altering the relative costs of living in particular tenures. Private renting has been on the bottom rung of the housing political ladder for many years and, unsurprisingly, the tax and subsidy system has long tended to be biased against it.

Yet, before examining taxation problems in the privately rented sector, it is important to remember that housing as a whole has a light tax load and a heavy subsidy lift compared to many other activities. So, any problems with private renting as a tenure need to be tempered by the fact that rental housing consumers (and, hence, residential investors) gain from the general housing beneficence of governments as well as those living and investing in other tenures.

Justification for treating housing so favourably is often couched in the moral terms of shelter as a basic human need but, as there are few cut-off points, most of the tax benefits apply right up the scale to profound luxury and locations of the highest status and convenience. Installing a splendid conservatory or moving to a smarter location for an owner occupier, for example, is more tax efficient than buying a large car or expensive TV – though why is hard to justify. The distributional implications of many tax breaks are also regressive in that the better-off and the more expensive homes often gain the most.

The light tax load has been compounded by quirks in the tax system. An important factor in housing is that second-hand durable goods are not covered by VAT. Consequently, the housing services released from the existing stock of housing and the benefits of living at some locations rather than others incur no VAT liability, whereas many other consumption activities do. Repairs and improvements are caught within the VAT tax net, however, so older dwellings eventually end up generating much VAT. The outcomes are perverse. Up-graded houses in the grandest locations rise in value as a result of repair and improvements by far more than do those in the worst ones. Even so, the VAT tax liability per £ spent is the same.[6]

Unlike most other EU countries, new housing is not subject to VAT. As many other consumption activities incur 17.5% VAT, the incentive to splash out on new housing rather than other consumption activities in the UK is high.

Possible tax reforms

The lack of consistency in the housing tax system and potential feedback effects, as well as the generosity of the overall tax burden, create the need for complex strategies for reform that involve 'second-best' responses. Imposing VAT on new build, for example, might discourage housing supply. Yet, if that argument is right, a corollary should be that VAT is not imposed on repairs and improvements of older dwellings either, in order to avoid distortions in favour of new build over older buildings and conservation. This would be of particular benefit in the privately rented sector where older housing and lower repair levels prevail (see Chapter 5). However, the recent Barker Report[7] argued against such a policy suggesting that there would be a large deadweight loss of foregone taxation on works that are already carried out and that better-off homeowners would benefit the most from the removal of VAT on repairs and improvements.

A useful principle when contemplating lowering the tax generosity of housing should be that it is better to tax housing consumption than housing supply – though development land is another matter. Housing supply is widely accepted as being far too low, for a variety of reasons explored in the aforementioned Barker Report. Taxing supply makes the matter worse. For this reason, a property tax based on annual property values is one of the better tax reforms suggested in recent years.[8]

A stamp duty anomaly

The taxation of private landlords in several respects is similar to that of businesses in general in that costs can be offset against revenues before tax is charged, but differs in several ways. In particular, residential property companies face one expensive tax quirk with respect to other companies, because of their line of business and the nature of stamp duty on residential property.

The problem arises with stamp duty thresholds. The value of individual rental dwellings may well fall within one of the lower tax bands. Yet, if purchased jointly when a block of flats is bought, a higher threshold value is triggered on the whole value of the acquisition. Taxation policy, thus, discriminates against block purchases and is at variance with government policy which aims to increase the role of larger providers within the privately rented sector. This measure particularly discourages larger investors (and any potential future PIF), because they are only likely to be interested in bigger single investments, such as the purchase of residential blocks of flats.

Private individual landlords and mortgage interest tax relief

Private individual landlords pay tax on the income, net of costs, from their residential investments at their marginal tax rates. The biggest beneficiaries from such tax reliefs are those on higher marginal tax rates. The better-off consequently can gain more from being landlords than those on lower tax levels, particularly if they borrow in order to recoup interest tax relief.

Since the recent abolition of mortgage interest tax relief for owner occupation, investing in privately rented housing has become a relatively better way of maximising tax benefits, especially for higher marginal rate individuals. A UK taxpayer, for example, cannot claim tax relief by borrowing in order to invest in equities but they can by taking out a buy-to-let loan. This tax gain means that the privately rented sector in equilibrium can operate on a lower pre-tax return than other less-tax efficient investment vehicles.

In reality, as early chapters showed, the privately rented sector currently is under-mortgaged with many landlords not taking advantage of tax reliefs. This is likely to change in the future as more residential investors realise the gearing and tax benefits of relatively high levels of borrowing. An implication, of course, of this forecast increase in mortgage borrowing is that the Exchequer's tax take from the privately rented sector should fall significantly over time.

Individual landlords and running costs

Individual landlords that use agencies to manage their properties have to pay VAT on those services but can offset the costs against rental income and, thereby, reduce their tax liabilities. Landlords that do their own management are not liable to pay VAT on those services, but neither can they offset their efforts against tax. There have been objections to this situation as it seems to imply a tax on personal effort.[9] However, the picture has another side. If management DIY landlords could include notional management costs as tax deductions, symmetry would suggest that they are then generating an income-in-kind for themselves. If this income-in-kind were taxed that would offset the benefit of the proposed tax deductibility of DIY management costs. Both landlords and the Inland Revenue would be involved in greater administrative effort necessary to monitor, claim and process the in-kind cost claims and income charges, with little net effect on overall taxation. The deadweight costs of such measures, therefore, suggest that they should not be implemented.

Individual landlords and capital gains taxation

Private individual landlords are subject to capital gains taxation (CGT), less permitted indexation and costs,[10] excluding initial allowances,[11] when they sell properties. CGT is charged at the person's marginal tax rate. There is also a taper on CGT charges: after 2 years of ownership, 5% of the tax is waived for each subsequent year of holding up to a maximum discount of 40% in the tenth year. This taper obviously encourages landlords to hold onto their properties until they maximise the tax relief.

Taxable capital gains arise from any increase in the value of the property due to general house price inflation, any local relative increases in house values and, also, the impact on the value of any property of repairs and major improvements to it. The indirect imposition of CGT on repairs and improvements is another tax disincentive on private landlords to repair their dwellings. It drives a further wedge between the costs and benefits to landlords of providing high and low quality property.

In contrast to landlords, owner occupiers are not subject to CGT on sale after a minimum six month period of living in their principal residence. This tax break currently costs the Treasury £10.5bn a year – though this figure may be exceptionally high because of the current house price boom in the UK.[12] So, homeowners do not face the same CGT disincentive to repair and improve that exists in the privately rented sector.

There is another anomaly of CGT in the privately rented sector. Unlike companies, private landlords cannot rollover this liability between assets, because for them residential property is not counted by the Inland Revenue as a 'business asset'.[13] This is an important disadvantage as it discourages personal landlords from trying to optimise their residential portfolios or from changing them in response to shifting patterns of demand. Removing the anomaly is complex, however, given the far higher taper relief currently given for business assets.

The tax position of landlords and owner occupiers compared

There are several differences between the tax situation of private individual landlords and owner occupiers.

Two differences are mirror images of each other: landlords do not get relief from CGT and owner occupiers cannot offset interest payments related to their properties against tax liabilities. Whether one or the other is a better benefit depends principally on the relative magnitudes over time of interest rates and annual increases in house prices. Ignoring allowable deductions and assuming that general price inflation affects interest and house price inflation rates the same, the benefits of either depend on the relative rate of change of interest rates and house price inflation. The trend rise in real

house prices is high in the UK at between 2.5% and 2.7%,[14] so the CGT relief benefits those UK owner occupiers more than those in lower trend house price inflation countries where such tax breaks are also given to owner occupiers. Yet, over the long-run, the benefit of each type of tax break is anyone's guess; though the fact that CGT is imposed at the time of sale, with an initial tax free element and contains a marked time taper, whereas interest tax relief (ITR) applies to interest rates in full and is recoupable in the current tax year suggests that over the long-run ITR may be more advantageous.

The short-run situation, nevertheless, can be different from the long-run one. Both house price rises and interest rates go through cycles and those cycles tend to move in opposite directions. Since the mid-1990s in the UK, for example, nominal interest rates have been falling significantly, while house prices have been rising rapidly. The pendulum consequently has favoured CGT as the better tax break over the past decade and, hence, benefited owner occupation over private renting. Prospects for the future suggest that the pendulum may swing the other way, with higher nominal interest rates in prospect and lower annual house price rises for several years to come. This means that the relative tax benefit could now be swinging back in favour of privately renting over owner occupation.

The other main tax difference between the privately rented sector and owner occupation is the tax treatment of rental income. On the one hand, landlords have to pay 'Schedule A' tax on their rental income net of current costs.[15] Owner occupiers, on the other hand, do not pay such a tax on the (imputed) rent they as 'tenants' implicitly transfer to themselves as 'owners/landlords'. The tax difference per equivalent dwelling consequently is currently substantial, especially as many landlords do not offset this tax by gearing in the ways described above. However, as borrowings become more common in the privately rented sector, the differential between the tax efficiency of the two tenures will narrow, because significantly smaller shares of landlord's gross rental income would be subject to tax.

The tenure tax burden, in summary, is a joint product of tax rules and how decision makers in each housing tenure respond to them, but the absence of Schedule A tax favours homeownership over renting. If landlords become more financially and tax savvy, the relative tax incidence of the two tenures should become narrower, especially as over the long-run the benefits of ITR are likely to outweigh those of non-imposition of CGT. This conclusion, however, does not hold over the housing market cycle, when tax effects are likely to cause shifts in both demand and supply in each tenure – with the direction of those shifts depending on relative changes in house prices and mortgage interest rates.

The potential for tax arbitrage

There are many ways to look at the impact of tax on housing markets. One way is to take a structural view and see whether households as groups can choose housing investment and consumption options that minimise their joint tax and housing cost payments. This issue is generally known as tax arbitrage.

The simplest way to conceive of this proposition is to imagine two groups of households, one paying a higher marginal rate of income in tax than the other and, then, think about the way the higher tax group can use tax breaks in privately rented housing to make housing available to lower taxed groups. The latter indirectly share in the tax benefits because the tax-induced extra housing supply leads to lower rents for them.

In the current UK tax situation as described above such tax arbitrage is possible, particularly when those on higher tax bands borrow mortgages to fund the purchase of dwellings that they rent out to those on lower tax bands. In this way, the total tax take of both groups is minimised and the higher band households

share some of their tax breaks with lower income households through reduced rents. The lower income groups, consequently, have less incentive to move into owner occupation.[16]

The prediction of the tax arbitrage model is that better-off households will provide rental housing for lower income groups, who may have lower incomes simply because they are younger. Unfortunately, the empirical evidence to date has not offered much support for the tax arbitrage model. First, as noted above, the recent phases of the housing market and interest rate cycles have strongly favoured the CGT break offered to homeownership. Second, financial liberalisation with respect to the privately rented sector is still in its infancy, so the borrowings necessary to support the tax arbitrage effects have not been sufficient to have an impact on privately rented as a whole, at least in the UK. Third, the running costs of privately rented accommodation are significantly greater than those of owner occupation and this tends to counteract potential tax arbitrage benefits. Management problems, moreover, are often greatest in the cheaper parts of the privately rented sector and this is the sector where tax arbitrage effects are likely to be the most pronounced. Tax arbitrage in the privately rented sector consequently seems to be more of a theoretical possibility than a practical outcome, although it may become more important as house price growth moderates in the UK and mortgage interest rates rise.

1 Turnover rates of tenants were examined in Chapter 3.

2 ARLA *Review and Index of Returns on Residential Investment*.

3 These figures are derived from a variety of sources including ARLA, London Residential Research and A. Crook et al *Investment Returns in the Private Rented Housing Sector*, 2002, British Property Federation, London.

4 The deadweight cost calculation can only be imprecise because the high turnover rates in private renting to a degree provide economic benefits.

5 As actual landlord returns cannot be easily measured, there are several published notional return calculations. The actual level of returns recorded in them, of course, depends on the assumptions made. Those released by London Residential Research, for example, typically produce more pessimistic returns data than those shown above.

6 Though a vibrant no VAT residential improvement and repair industry has grown up, either because builder proprietor turnovers are below the VAT threshold or because they fail to charge VAT.

7 K. Barker *Review of Housing Supply – Final Report*, HM Treasury, 2004.

8 See J. Muellbauer *Safety in Property Tax*, http://www.housingoutlook.co.uk/Papers/ft0702.html.

9 See, for example, the recent JRF/Shelter report *Fair Deal for the Privately Rented Sector*, 2003.

10 Indexation is allowable for the effects of inflation up to April, 1998; permitted costs are items such as the legal and agency costs of acquiring the property.

11 The first £8,200 of the chargeable gain is not subject to taxation in 2004-5. This allowance is indexed and changes annually.

12 Treasury *Budget Report*, 2004. A tax take and tax relief balance sheet is not published for the privately rented sector, so the magnitudes of tax for it are unknown.

13 See *Capital Gains Tax*, Inland Revenue Personal Taxpayer Series CGT1.

14 See Barker Report, ibid.

15 'Rent a room' landlords, however, have a £4,250 exemption on annual gross rent. See *Letting and Your Home*, Inland Revenue Personal Taxpayer Series IR87.

16 Technical demonstration of this tax arbitrage effect and a discussion of actual outcomes can be found in G. Wood 'Are there tax arbitrage opportunities in private rental housing markets? *Journal of Housing Economics*, *2001*, 10, 1-20.

CHAPTER SEVEN

Summary of findings and policy implications

Introduction

The previous chapters have undertaken a lengthy analysis of the privately rented sector. This chapter summarises the main points and the conclusions drawn from them. Policy recommendations are identified. A final section draws the major policy themes together.

Summary and conclusions

The main points of this report are summarised below. Where they have a direct policy consequence an asterisk is assigned to them.

Overview

- The overall size of the rental sector in the UK is around the international average, but exceptional reliance on social housing makes the privately rented sector one of the smallest at 10-12% of the housing stock.

- The revival of the privately rented sector over the past fifteen years has been underpinned by deregulation that has for the first time in three-quarters of a century allowed market forces to work effectively.

- Deregulation enabled the unleashing of several key drivers in the growth of the privately rented sector: financial liberalisation and competition, rising investor wealth and improved perceptions of landlordism, rising property values, reduced tax breaks for owner occupation and higher demand caused by rising standards of living, more students and increasing barriers to entering owner occupation.

- Privately renting is greatest in South East England, university and seaside towns, and some large cities – especially London.

- Housing standards are generally good. Few dwellings are overcrowded; a third are flats, but most are houses; the majority have access to gardens or terraces. The privately rented stock is generally older than in other tenures with 60% built before 1945.

- The privately rented sector consists of many segmented markets serving different types of client, such as lodgings, short lets, furnished and unfurnished accommodation, unsubsidised and housing-benefit tenants, plus marked geographic specialisation.

- An expansion of private renting at the expense of owner occupation has no clear economic or social justification.*

- This study has not considered social housing in detail, but it would benefit from operating more on market principles like the privately rented sector.*

Who rents, with what effects?

- Tenants are highly mobile: a third move within a year, two-thirds within three years.

- Moves are mainly within the privately rented sector. Cross-tenure moves are not particularly different from other tenures.

- Private renting now is most commonly a tenure of transition in that the majority of tenants will become owner-occupiers at a later stage of their housing careers.

- Most tenants are young adults: almost two-thirds are aged less than 35 and a quarter under 25.

- The youngest households pay the highest rents and the oldest the lowest.

- Most privately rented tenants are in work in sharp contrast to the socially rented sector.

- In terms of household types: two-fifths are couples, a third singles; sharers represent a fifth and single parents a tenth.

- The income distribution of privately rented tenants is similar to the national distribution of income of all the three main housing tenures.

Future demand

- The young adult age cohort is expected to decline in absolute numbers between 2002 and 2016. At the national level, the fall is not great but in South East England and London, especially, the fall will be significant at over 10%. If this forecast is correct, it could lead to a shrinkage of the privately rented sector.

- Counteracting such population changes is likely to be an increase in the wealth barriers to owner occupation, forcing more younger adult households to remain in the privately rented sector for a longer period. In the short run, however, the demand for privately renting might temporally fall once the current house price boom is over, as some tenants will then move into homeownership as house price to income ratios decline.

- A reform of social housing would increase demand for private renting.*

- No large-scale increase in the privately rented sector can be expected in the near-future in the absence of reform to social housing.*

Mobility and the labour market

- Mobility may be high in the privately rented sector but that does not mean more privately rented dwellings would necessarily increase overall labour mobility. As most working people are owner occupiers, the country actually needs more owner occupied dwellings in order to increase labour mobility.*

- Social problems such as divorce and family break up also mainly occur within owner occupation.*

- Housing supply-side constraints are the biggest factor constraining labour mobility. In order to improve labour mobility, extra housing is needed, in order of priority, in owner occupation, private renting and social housing.*

Housing benefit and privately renting

- Far fewer private tenants have their rents subsidised by housing benefit than twenty years ago, whereas the numbers are roughly the same in social housing.

- Housing benefit does not work well. Administrative problems are an important difficulty. Housing benefit is unpopular with most private landlords.*

- *De facto* rent controls in the privately rented sector were re-introduced with 'reference rents' set in relation to housing benefit. This has helped to create quality problems.

- The current Pathfinder experiments with Standard Local Allowances seem to be working, but they do not resolve the fundamental problems of housing benefit.*

- Housing benefit authorities should take on a greater advocacy role to ensure that tenants have means to complain when landlords do not stick to contractual agreements. This should be applied in both the private and social sectors.*

Ownership and investment

- Many lettings are owned by private individual landlords. Corporate landlords have continued to withdraw from the sector. Most investors in the privately rented sector,

including both private individual and corporate ones, do so as a sideline to their principal activity.

- There seem to be low economies of scale in privately rented investment and management, which helps to explain the successful growth of the small investor. Large investors, however, can still prosper.

- There is no reason to expect that small investors are 'worse' landlords on average than larger ones.

- Landlord-tenant relationships generally are better in the privately rented sector than in social housing. This is because they have incentives to get on.

- There is a need for improved public information on issues associated with the privately rented sector for both tenants and landlords.*

- Tenant deposit disputes are an area of concern, but are likely to be best dealt with by private initiative. The Government's current 'wait-and-see' policy seems wise as private initiatives are currently emerging.*

- The management of lettings and tenancies has been improved by the growth of lettings agencies.

- The buy-to-let boom has been spectacular, with 400,000 outstanding mortgages by the end of 2003 from zero at the beginning of 1998.

- The privately rented sector, nevertheless, is still heavily under-borrowed, with only a third of properties mortgaged. As a result, mortgage lending should grow and is likely to.

- There is no evidence of an impending crash in the buy-to-let market.

- Proposals to introduce Property Investment Funds (PIFs) as tax efficient investment vehicles will benefit the privately rented sector.*

- PIFs will not generate dramatic changes to private renting because of the tenure's sheer scale at almost 2.5 million dwellings.

- Yet, PIFs will be particularly beneficial for stimulating the provision of new blocks of flats in cities and, where possible within planning guidelines, planned communities.

- PIFs could be a useful policy tool in urban regeneration.*

- PIFs could be expanded into areas traditionally within the remit of the social housing sector to provide a cheaper, more efficiently operated stock and improved housing services.*

Licensing and regulation

- The introduction of controls on parts of the privately rented sector, such as houses in multiple occupation (HMOs), may be well-intentioned but carries the risk of undesirable side-effects.*

- It is not clear that a full cost-benefit analysis has been undertaken of proposals to regulate HMOs. The full impact of HMO licensing does not seem to have been assessed, nor is it clear that the desired outcomes will result. There is a substantial risk that the supply of HMOs will fall significantly in the face of higher landlord costs and uncertainties.*

- Safety issues are important, but a strategy of imposing zero risk in housing provision is neither feasible, economic nor desirable.*

- There is a danger that poor housing conditions in HMOs will still exist even after licensing, especially in a criminalised underworld of unlicensed premises.

- A tendency to introduce regulations whenever a problem is perceived threatens to create a climate of uncertainty amongst privately rented investors as a whole that could damage confidence and sharply lower overall investment.*

Dwelling conditions and repairs

- Government surveys paint a picture of a privately rented sector where dwelling conditions are notably worse than elsewhere, with, for instance, a fifth of dwellings identified in 2001 as needing £10,000 of repairs each.

- Landlord and tenant surveys, in contrast, indicate far lower concerns with condition and repairs.

- Official Housing Condition Surveys take an 'engineering-assessed full repair' approach to measuring housing conditions in all tenures, rather than consider an optimal state of repair for the housing stock. In doing so they exaggerate repair problems.

- This approach creates particular biases against the privately rented sector, where the housing stock is generally far older than in other tenures because of the nature of the markets served by it.

- It is important not to force landlords to repair up to engineering standards, otherwise rental housing supply is likely to decline drastically.*

- Housing benefit agencies should be obliged to undertake random surveys of properties to ensure that landlords are providing what is agreed.*

- The taxation of repairs and improvements contributes to lower rates of repair and modernisation and should be removed or reduced.*

Landlord returns

1. Costs

- Operating expenses in the privately rented sector are high because costs exist that do not arise to the same extent in other tenures. They occur because of the higher transaction costs associated with substantial tenant mobility, especially the impact of significant periods of time when dwellings are empty between lets; and higher management and wear-and-tear burdens.

- As many such costs do not exist in owner occupation, it is generally cheaper on a like-for-like basis. This, as well as consumer preferences, helps to explain why owner occupation is now the dominant tenure in the UK and most other countries.

2. Returns

- Net returns are currently very high in the privately rented sector because of recent house price rises.

- A decline in returns to more normal levels is unlikely to lead to a substantial fall in investment, because of the long-term under-representation of residential rental property in most households' and institutions' investment portfolios.

Taxation

- Generally, housing is taxed lightly in comparison to other areas of consumption and investment. There is no obvious justification for this, particularly as there are few caps on the tax breaks, so that the better-off gain the most.*

- Taxation policies vary between individuals and corporate landlords in several key respects. Net rental income, for example, is taxed at private landlords' personal marginal tax rates. For corporates, it is taxed at corporation tax rates and any distributed profits are taxed at shareholders' dividend income tax rates. Property Investment Funds (PIFs) will create another tax regime – with only dividends being taxed.

- Many corporate landlords, especially sideline investors, because of their characteristics as trusts or public bodies have no corporation tax liabilities. Others can pool residential tax liabilities with the main parts of their business. Sideline corporate investors tend not to adopt a commercial attitude to residential property, but their tax status partially shields them from the financial consequences.

- Tax pooling for individuals is not allowed in the UK, though it is in some other countries, such as in Australia. It is probably not a good idea to introduce tax pooling for private individual landlords as it may encourage market de-stabilising investment activity.*

- There is a stamp duty anomaly for corporate landlords in that they have to pay the highest rate of duty when buying blocks of apartments even though individual units within them may fall into lower duty bands.*

- Individual landlords cannot transfer liabilities for capital gains tax across their property assets, which limits their flexibility in response to changing patterns of demand.*

- Arguments that private landlords unreasonably cannot claim tax-deductions for their own management time ignore the fact that currently the income they save from doing so is also not taxed as an in-kind benefit.

- Comparing the tax positions of private landlords and owner occupiers, landlords pay capital gains tax (CGT) – though at a declining rate the longer they hold their properties – but can claim interest tax relief (ITR); whereas the opposite situation exists for homeowners. Over the long-run, ITR is likely to be more beneficial than the CGT exemption, especially when landlords are appropriately geared.

- Private landlords are currently under-geared (leveraged) on average and so lose out on ITR benefits.

- Homeowners' imputed rental income is not taxed, whereas most landlords pay taxes on their net rental incomes. This difference represents a taxation bias towards owner occupation. However, if landlords borrow, ITR can be offset against rental income which can significantly lower the bias.

- There is little likelihood that tax arbitrage works in the UK, whereby better-off households facing higher marginal tax rates borrow and let out rental property to households in lower marginal tax bands.

A policy framework to improve the future of the privately rented sector

Many policy issues have already been flagged up in the previous section and there is little need to repeat them again. However, there are a number of overarching themes related to regulation and policy frameworks, taxation and investment that still need to be drawn together.

1. Regulation and policy frameworks

Avoid over-regulation and legislative uncertainty

Concern has been expressed in this report that the policy climate is moving away from a support for free market processes in the privately rented sector to greater control and regulation. It is important not to stifle investment in privately rented housing through an excessive bureaucratic burden. Clear, strong and consistent commitments to a market-oriented privately rented sector need to be made by policy makers.

Create transparent legislative frameworks

Complex legislation only becomes clear in its consequences several years after introduction, as the regulations are tested in the courts and ministerial interpretations are made. The

measures contained in the current Housing Bill with respect to the privately rented sector are such an example of complex legislation. In particularly, it may have far reaching consequences for HMOs. In Scotland, in any case, similar measures are already law. Nevertheless, it is important to limit any further uncertainty that may be generated amongst landlords to avoid damage to investor confidence. With this in mind, it is important to ensure consistency across local authorities in the implementation of their new powers and make sure that a light touch rather than a heavy hand becomes the standard guideline.

The need for a positive perspective

The revival of the privately rented sector over the past fifteen years has been an extraordinary success. The attitude of much policy commentary, however, continues to have negative undertones.

The worst criticism that can be made of a private landlord still remains in many quarters that 'they are only in it for the money'. Yet, that is precisely the point about supply in a market-based system – it is there because people want to make money – and housing is no different. Being in it for the money does not make a landlord a bad person, nor one who treats tenants badly or cheats them. Such behaviours, when they exist, instead mean that landlords must have other less savoury motives than mere money-making ones, because, as was pointed out in earlier chapters, they are not usually profit-maximising ones.

Another common view is that there is always a proportion of landlords that are up to no good and that tough regulations on all landlords are necessary to constrain the cowboys. This view is again misplaced and not universally applied in other lines of business for good reason – many rules can easily end up imposing more costs on an unexpectedly wide variety of people than providing benefits. Some of the issues over the unintended consequences of regulations with regard to the privately rented sector have been explored earlier in this report.

A more positive attitude to the privately rented sector is much needed, particularly amongst local authorities. Devolved governments have also been far quicker to control the privately rented sector than to encourage it, despite deep-seated housing problems, deficits in housing investment and significantly lower shares of private rental housing than England.

The final policy attitude worry is that in its new successful state, the privately rented sector may become a policy instrument to be set targets and cajoled into meeting them on the strong assumption that the analysis underlying the policies is unfailingly correct. History, instead, has shown that policies towards the privately rented sector are usually inappropriate.

2. Taxation reforms

Several taxation reforms have been suggested in this report. Two are related to the purchase and sales of rental properties. These are removing the stamp duty anomaly associated with the purchase of blocks of flats, where the individual flats fall into a lower stamp duty band; and allowing individual private landlords to transfer CGT liability when they sell and purchase properties.

The major tax changes suggested, however, relate to repairs and improvements. As concern exists over repair levels and housing quality in the privately rented sector, it seems perverse to tax them. Building works to individual properties also generate externality effects by improving general neighbourhood quality. They also boost general housing supply.

A tax incentive approach to improving housing standards, furthermore, is a much better alternative than a regulation approach that tries to force landlords to raise standards. The regulation route is likely to fail because it imposes costs and uncertainties, which consequently lead to a significant withdrawal of

investment. The tax break route, in contrast, lowers costs and so encourages extra investment.

The proposals are, either:

1. To remove or reduce VAT on landlords' repairs and improvements. The aim would be to encourage further investment in repairs and upgrading the rental stock. Practically, this may prove difficult to implement, however, because of the need to apply tax rules fairly across all activities, as owner-occupiers, for example, would still be charged for them.

   Moreover, such a reform would face the objections outlined in the recent Barker Report (see Chapter 6).

2. To provide other taxation inducements to the upgrading of the conditions and the amenities of the 'available to the public' privately rented housing stock. In some localities, improvement grants already exist and some tax reliefs with respect to insulation and other environmental matters have also recently been introduced. Yet, there is a case for offering depreciation allowances on repairs and improvements in order to encourage landlords to undertake more investment in their existing dwellings.

Such depreciation allowances should ideally be conditional ones. With regard to repairs, for example, in order to claim the allowance landlords could be required to show proof of average annual repairs expenditure at least as large as some predetermined sum. That predetermined sum could be set at a level implying that a dwelling remains in a good state of repair and vary in amount for dwellings in each council tax band. The size of the predetermined sum, the depreciation charges allowed and the averaged period over which repair expenditures were accessed would need to be determined from estimates of the likely responses of landlords' repair expenditures to tax incentives.

Any tax breaks introduced would need to be ring-fenced so that the properties remain in the privately rented sector. This could be done by having claw-back provisions. Foregone taxes could be re-imposed if the dwelling is no longer market-rented, for example, on a declining scale for, say, a five or ten year period from the granting of the original tax break.

It is difficult to estimate the full cost of such measures. A rough estimate, nevertheless, is possible of the gross VAT tax take on repairs. At present, there are around 2 million available to the public privately rented dwellings in England. Surveys suggest that landlords spend on average £500 a year on repairs. Some will not be charged VAT, but for simplicity, assume all pay 17.5% VAT on top of the £500. This gives a tax take of £175m a year, though this is then partly offset by repair costs lowering Schedule A rental income tax revenues.

If repairs and improvements are excessively low in the privately rented sector, as is often claimed, the leverage effect of tax breaks in inducing additional expenditure could be substantial. Deadweight tax losses to the Treasury on work that would have been done in any case would be partly offset by the extra tax revenue likely from the increase in rental income arising from the existence of better quality in the privately rented sector.

With so little information to go on, it is hard to evaluate what tax breaks would be required to increase investment where it is needed. The argument in Chapter 5 suggested that the repair and improvement deficit might not be as great as some surveys suggest. It would probably be best to undertake some pilot experiments to observe the extent to which landlord investment was sensitive to such fiscal stimuli.

3. Housing investment

The big current housing problem in the UK is a lack of adequate housing supply in areas where demand is high. Incentives for private landlords

to invest in stimulating new supply are currently absent. The introduction of PIFs may help but there is also a need to consider the role that the privately rented sector can play in stimulating supply further. Grants could be offered to build in localities or in built forms where currently supply is insufficient, but not constrained by planning controls – particularly urban regeneration areas. Similarly, the blanket use of affordable housing criteria in planning obligation requirements to provide new social housing could be adjusted to provide more privately rented housing as well.

Conclusion

A series of reforms have been suggested here, but the overall message is that the growth of the privately rented sector over the past fifteen years has been a major success. That success has primarily been market-driven, yet still it is one in which policy has played an important part. Success has come about by allowing a free market to operate and the forces of competition within it to work. The UK as a whole is highly unlikely again to become a nation of private renters, but the tenure once more is playing a key and sustainable role in housing provision. The objective of policy should be to keep it that way.

The Social Market Foundation is an independent think-tank which explores ideas linking the state and the market to create the just, free and prosperous Britain of tomorrow.

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