Where is housing heading?

What role for social renting in the new world?

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*Keith Exford*
Affinity Sutton chief executive
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In December 2013, CIH began a new series of policy discussions on the key issues facing housing over the next five years

Two years after the coalition government published its housing strategy *Laying the Foundations*, and 18 months ahead of the General Election, we wanted to take the opportunity to pause and consider developments since 2010: where we have ended up, what’s worked, what hasn’t, what we’ve learnt about the policy positions of the main parties and where things might be heading next.

We’ve commissioned a series of leading commentators to give us their views on these and other issues across different policy areas over the coming months. In this sixth essay, Affinity Sutton chief executive Keith Exford argues the case for affordable, rented housing and in particular the role of social or low-rent housing.

We hope you will enjoy the essays and that they will stimulate debate over the critical period we are about to enter.
6. What role for social renting in the new world?

Why does Britain have such a dysfunctional housing market?

Why do we have a relentless wave of price booms followed by market collapses and why do house prices and rents vary so much, even in adjoining neighbourhoods? Why does demand for affordable and social housing outstrip supply in some parts of the country while in others, we have been demolishing low-demand family homes for which people would queue around the block if only they were in a different place? And why are social rents in some areas attractive even though they may be higher than market rents while in others they are unaffordable even when they are set at a fraction of the market price?

Of course, it’s all terribly complicated. There’s a widely accepted view that we are just not building enough new homes and it’s clear that under-supply has a profoundly detrimental impact on housing costs – to rent and buy – and has led to rationing systems, where access is determined by price or ‘need’.

This paper concentrates on the case for affordable, rented housing and in particular the role of social or low-rent housing. So let’s start by understanding better the shape of affordable rent policy in England; explore what we mean by affordability and conclude by looking at what works best for tenants, tax payers and housing providers.

Housing policy? What housing policy?

In short, we have many, many housing initiatives but no coherent, national housing policy, let alone a considered approach to rents and affordability. In fact, social housing rent policy is a mess with the rents charged to different tenants more a reflection of when a tenancy was created and the prevailing funding or regulatory regime at the time than any coherent reference to ‘affordability’. This is worth unpacking to understand just how illogical and complex the system has become.

The rent morass

Local authority tenants pay rents determined by their council which can vary widely from one council to another, even in adjoining locations. For the last ten years, these rents have been expected to inflate steadily to reach government determined ‘target rents’ using a formula derived from local property prices and local incomes. Progress in reaching the ‘target’ has been variable to say the least.

Longstanding housing association tenants might pay a ‘fair rent’ set independently of their landlord by the rent officer. Their neighbour might pay a ‘target rent’ (as described above), or a rent which has never converged and which therefore could be higher or lower than the target. Or, they might pay an ‘affordable rent’ which could be anywhere between 50% and 80% of the market rent. Higher-income tenants might be paying a market rent, and in London from 2015 onwards, we will have ‘capped rents’ and ‘discounted rents’ too. And of course, those paying fair rents and target rents may in addition be paying service charges. In some schemes, these service charges might bring the total costs of renting a flat to a higher all-in cost than renting a family house with a garden. Oh, and the rents for some larger properties are not that different to those for smaller ones.
So what does it look like in practice?

On a typical Affinity Sutton estate in high-value Islington, the rents range from very low - under £80 pw for a ‘fair rent’ – to very high, at £290 pw for a new ‘affordable rent’. And by virtue of their long tenancies, most of our tenants on that estate are paying far less than we are expected to charge. With the government’s decision to abandon rent convergence after 2014, they will continue to enjoy that ‘discount’ for as long as they retain their tenancy. Understandably, turnover on the estate is low; even a significant improvement in personal financial circumstances will not offer enough incentive to free up a home for someone in urgent housing need.

Confusing? Unfair? You bet.

**So what about affordability?**

There have been countless reports and reviews into what we mean by affordability and where rents should be pitched to ensure tenants can have a decent standard of living while being encouraged to take up work and become less dependent on benefits. Most of these have tried to define affordability by using one of four key measures.

The first and most common approach is to measure the rent to income ratio, typically suggesting that rent should not exceed 25-35% of income. This is easy to understand but doesn’t relate to the amount a given family needs to live on after paying their rent.

The other methods are designed to measure disposable incomes after housing costs. One approach is to define a minimum standard of living. An alternative takes the ‘poverty line standard’, and assumes that disposable income (i.e., after housing costs) should be at least 60% of national median income or 120% of income support levels. The final approach deploys a ‘Minimum Income Standard’, derived from work by the Joseph Rowntree Foundation.

**Just too difficult?**

All of these approaches have strengths and weaknesses but most studies fail to recognise that it is arguably impossible to improve affordability through rent levels alone. If for political and economic reasons we are prepared to countenance low incomes then high housing costs can only be defrayed through subsidising rents. Hence there is a vital interplay between incomes, rents and the welfare system. Responsibility for policy in each of these falls within the remit of different government departments - and it shows in the lack of co-ordinated policy. No-one in government seems responsible overall for taking it on.

**Britain’s low-pay economy**

There is much political rhetoric about which European and global economies will emerge strongest and quickest from the recession and how wage rates might impact on their competiveness and prospects. Writing in the *Social Europe Journal*, the economist George Tyler observes:
‘Aside from the banking sector, Britain seeks international advantage by using American-style wage compression. That has occasioned labor remuneration to grow faster in France and across northern Europe since 2000. In 2012, average hourly wages in France ($27) and Germany ($30.5) were 25 and 41 percent higher than in Britain ($21.6)... Indeed, UK wages are no higher than long-stagnant US wages which also lag northern Europe. They lag because labor compensation has largely stagnated in Britain since 2000 while marching ahead in purchasing power terms in France and Germany. Worse, British wages have fallen in real terms since the first quarter of 2010 according to Britain’s Office of National Statistics.’

Tyler goes on to argue that low pay will not compensate for Britain’s lower productivity:

‘More competitive French and German firms can compete with British firms despite paying higher wages because their employee costs do not rise as fast as productivity growth’.

So with a shortage of housing supply across all tenures at least contributing to housing cost inflation and pay failing to keep pace with the growth in rents, the obsession in some quarters with replicating the greater use of private renting in other northern European countries appears at best simplistic – British pay rates are too low, especially for unskilled work, to make market prices affordable without support from the benefit system.

In many countries, housing costs are relatively lower because more land is released for development and the mismatch between supply and demand is narrower. For example, as Kristian Niemietz points out in his blog on rent controls for the Institute of Economic Affairs, Germany has no ‘green belt’ no ‘Campaign for the Protection of Rural Germany’ and no National Trust objecting to concreting over the countryside. This goes some way to explaining why German house prices and rents are relatively constant.

Finding an answer to the affordability conundrum is difficult. But surely we should be capable at least of developing a fairer, more coherent approach to rents that enables us to design a sensible subsidy system. The concluding part of this paper makes what should be a self-evident point – that sub-market housing needs subsidy - and argues for a return to a predominantly supply-side subsidy system based on social level rents rather than supporting market or near-market rents through housing benefit.

**Known knowns and unknown answers**

To coincide with the Budget 2014, the Office of Budget Responsibility (OBR) published its *Economic and Fiscal Outlook*. This includes a commentary on trends in welfare spending and acknowledges the growing number of working households that have become dependent on housing benefit.

In his post-Budget 2014 analysis, *Inside Housing* columnist Jules Birch draws upon the OBR report to point out that:

‘The largest driver of the rise in spending on housing benefit has been caseload growth in the private rented sector. This reflects both a rising share of households living in private rented accommodation and a rising proportion of those households claiming housing benefit. As a result, the share of spending accounted for by the private rented sector is forecast to rise from 30 per cent in 2007/08 to 40 per cent by 2018/19.’
The OBR says also that:

‘The rising proportion of the renting population claiming housing benefit may be related to the weakness of average wage growth relative to rent inflation. This explanation is supported by DWP data, which suggest that almost all the recent rise in the private-rented sector housing benefit caseload has been accounted for by people in employment.’

This is significant because it challenges head on the so-called ‘strivers and skivers’ polemic - the greatest growth in the housing benefit bill is from (so called ‘hard-working’) lower-income households that have little choice but to claim benefit to meet unaffordable private sector rents. So while housing costs are obviously a big contributing factor, an equally significant issue is low pay: there are now 20 million households on income-related benefits. Unaffordable housing is as much about low pay as high rents.

If affordability is a growing issue for working households when even low-cost homes to buy are out of reach to those on modest incomes, there may be a role for a range of ‘affordable’, regulated housing products at a range of price points for households on a range of incomes. This would be a more efficient and predictable option in public spending terms than housing benefit-subsidised private rents.

There are those that argue that the growth in private rents should be curtailed by regulation. Others, legitimately in my view, raise doubts about the adverse impact this could have upon supply. Although there is a clear case for ensuring private landlords meet minimum standards of performance, there are significant risks in trying to control rents.

Research by Affinity Sutton with PwC and Hometrack into the case for housing association investment in private renting appears to support such concerns. Since investment in private renting is not in itself ‘charitable activity’, charitable housing associations should expect to obtain commercial returns that reflect the risks inherent in investing their resources in market housing. In most areas, the net return from rents alone is insufficient: generally, appropriate returns can be obtained only through locking in ‘developer’s profit’ and releasing this over time through property disposals. Clearly any control placed upon rents will reduce the returns still further and almost certainly reduce appetite for investment.

New Cambridge University research into affordability

It’s clear that we need a better understanding of affordability and where rent-setting policy sits in trying to define it. With all the pressures on government finances and all the evidence pointing towards a relentless growth in housing benefit spending, it’s remarkable that there are no known plans for government to do a proper analysis of rents and affordability. This leaves a vacuum that individual providers are filling. For example, L&Q and the Chartered Institute of Housing published We need to talk about rent in 2013 and by the summer of 2014, Affinity Sutton will publish research we have commissioned from the Cambridge Centre for Housing and Planning Research to help us frame our own affordable rent policy.

The Cambridge work looks at the affordability of different types of rent in 27 local authorities throughout England. It looks at how rents should be set so that tenants should not be reliant on benefit and defines
affordability as leaving a residual income after rent of 120% of the income-support applicable amount - the base amount of means-tested benefits receivable. In that sense, it uses methodology deployed before but this does focus more on lower incomes. It also takes a close look at market rent levels.

Around two-thirds of social tenants receive either full or partial housing benefit. Under the current system all rent increases are fully covered by HB as long as rents are below the local housing allowance (LHA). Thus the workings of the welfare system are such that for the majority of tenants, rents can be set anywhere up to LHA without detriment to their residual income.

The logic therefore is to try to find a basis for setting rents that helps the minority who are paying their rent and those who, by facing lower rents, could be helped to avoid reliance on benefits. For those paying their rents, lower rents give them more income to spend on other essentials. So reducing higher rents makes the most sense, even more so if the rate of withdrawal of housing benefit could create a greater work incentive than now.

The research looks across the populations and housing markets in each of the areas reviewed and reveals some very interesting initial findings:

- Housing markets and rents vary widely, even in adjoining streets whereas the variation in lower level incomes is far narrower;
- The largest proportion of working households unable to afford market rents were usually lone-parent households but the largest numbers were usually single people. Couples generally find market rents more affordable but in London, over 25% of all working couples could not afford market rents. An intermediate rental product – ‘affordable rent’ (AR) can help many of these families;
- The spatial distribution of market rent unaffordability is by no means always concentrated in areas of highest housing pressure;
- Higher ARs create a greater work disincentive because the steep benefit taper means claimants retain only 35 pence of each additional pound earned. Working tenants benefit from more income although not from lower rent until they are off benefit entirely;
- Higher rents also mean it takes more income to get off benefit. But the main problem is that for some on low incomes, especially larger households, rents would have to be unsustainably low (often zero) if they were to get off benefit completely;
- It’s difficult to make general assumptions about the impact of the total benefit cap but ‘capped’ households are very likely to be single parents with 3+ children;
- Reducing AR in London from 80% to 65% of market levels has only a marginal impact on improving affordability, emphasising that AR is really an intermediate product;
• In higher-cost areas, rent affordability and the prospects of escaping benefit dependency are greatest when rents are set at or close to social rent levels. Conversely, in some lower-cost areas, AR is uneconomic to providers because even at 80% of the market, rents would be lower than social rents.

While the analysis of these initial findings continues, it is already clear that devising a market rent-related rent policy to help those on the lowest incomes is challenging to say the least. The ‘target rent’ approach, which takes into account the housing market and lower incomes, may not be perfect but it at least offers a sensible starting point for a more logical approach.

Who is social and affordable housing for – for how long, on what terms and at what rents?

Remarkably, these are questions rarely asked by policy-makers let alone answered. We need to do so if we are to design a coherent affordable rent structure, a range of products and the subsidy system needed to support them, and the welfare safety net to underpin occupation by low-income households.

Of course, the simple answer is that social housing should help those that cannot reasonably meet their housing needs in the market. The problem is that this means embracing an ever-wider range and greater number of low-income households. And in some localities, their pay rates will be far higher than many politicians will feel comfortable about helping. House prices and rents are increasingly out of kilter with pay rates.

95p in the pound

A fair and simple national policy on rents and affordability would help re-establish a clearer picture of the true cost and value of affordable housing and would form a basis on which to make more ambitious long-term commitments. It would give providers the certainty to borrow and build, investors the confidence to lend, tenants the clarity about the price of their housing and the taxpayer greater certainty about future public expenditure on housing benefit. As pointed out in the 2012 IPPR report Together at Home, if we are spending 95p in the pound of our public expenditure on housing in subsidising rents via the budget for housing benefit, there is something seriously wrong with the system.

Getting to grips with the supply challenge

Let’s not forget that the coalition government’s first spending review slashed capital spending on housing by over 60%, introduced higher affordable rents and made the shift towards a greater reliance upon demand-side subsidy.

The announcements in the 2015-16 spending review provided welcome certainty on future social rent increases. In addition, the government’s £10bn housing loan guarantee will help to attract long-term private investment at a competitive cost and potentially ‘off balance sheet’ funding for housing associations and local authorities. However, additional public investment is vital to delivering the social and affordable homes we need.
There is no evidence now or from history that the private sector alone is capable of increasing supply to the widely accepted level we need of around 250,000 new homes a year. There are not enough developers to do so, they don’t have the capacity and (this is not a criticism) they do not have the will or duty to do so. Without a significant increase in activity by housing associations and councils and public investment, we will continue to fall well short of delivering the homes we need.

Supply-side subsidy for social rents every time

Whichever way we go, sub-market housing needs subsidy.

In their report *The Numbers Game*, consultants PwC and housing association L&Q modelled a range of financing options for affordable housing supply beyond 2015. They looked at:

- a move to full market rents with housing benefit taking the strain;
- a continuation of affordable rent;
- a return to higher capital grant combined with lower social rents.

These three scenarios were tested against the overall public funding cost of providing 170,000 homes and 240,000 new homes a year, around half of which would be homes for sale, 25% for market rent and the remainder earmarked for affordable housing.

Even under the lower programme assumption of 170,000 homes, the cost to government expressed in net present value terms (NPV) over 40 years of relying on 100% housing benefit subsidised market rents was £53 billion whereas retaining AR produces a NPV cost of £45 billion. But reverting to a higher rate of bricks and mortar subsidy and charging social rents costs just under £40 billion over the same period.

A social rent programme of 42,500 homes a year would cost £15 billion in social housing grant, £43 billion in housing association borrowing and £28 billion pa in housing benefit. Relying on the market carries a slightly lower all in cost of subsidy of £41 billion pa – but with no asset for public benefit at the end, it carries all the risks and uncertainties about long-term availability, uncontrolled rent inflation and the inherent work disincentives of benefit dependency.

So it’s pretty clear. Housing at social rents for those on the lowest incomes and in the greatest need offers the best deal for tenants, taxpayers and providers. There is a role for affordable rents, for those unable to afford a home in the market. And no-one should deny the important role of a well-managed, reliable, long-term supply of market rental homes for middle to higher earners who do not wish or cannot afford to buy.

But spending 95p of every housing pound on benefit just doesn’t make sense, does it?