

The Barker Review of Housing Supply

Some Analytical Comments

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Introduction

1. The scope of the Barker Review is to examine the underlying causes of the lack of supply and responsiveness of housing in the UK. The note attached to the letter inviting submissions to the Review (hereafter ‘the Note’) states that

‘...the UK housing market displays relatively weak responsiveness in supply, highlighted by the comparatively low price elasticity of supply seen in the UK relative to other European countries and the US. This means that when demand for houses increases, output of houses tends not to increase quickly enough to satisfy this demand. One of the consequences of low elasticity is higher house prices than might otherwise be the case, resulting in problems of affordability and potentially shortages of housing.’

2. Unfortunately, the Note mixes up a number of important, but *separate* issues here. First, there is the question of whether there is convincing evidence that the UK has a weaker supply response than other countries, once one takes in account the fact that the UK has a large owner-occupied sector and hence low rates of inter-regional mobility. Second, even if the UK had a stronger supply response, there would still be a housing cycle since the supply response could never be strong enough to actually stabilize prices (and clearly prices are cyclical in other countries too). Third, it is only during the upswing of the housing cycle that a low elasticity actually implies that prices are higher than they would otherwise be. In contrast, during a downswing, a weak supply response will imply lower prices than otherwise.

3. Instead, this submission suggests that the important questions for the review to address are:

- i. Is the UK supply responses actually weaker than in Europe and the US, taking into account the various features of the UK housing market?
- ii. To what extent would a greater supply response help to stabilize prices at their equilibrium levels (relative to household incomes and expected real interest rates)?
- iii. What are the specific features of the UK housing market that might lead to a weaker supply response?

- iv. To the extent that the supply response appears to have been weaker in the recent upswing than in the late 1980s, what features of the UK housing market have changed that might account for this weaker response?

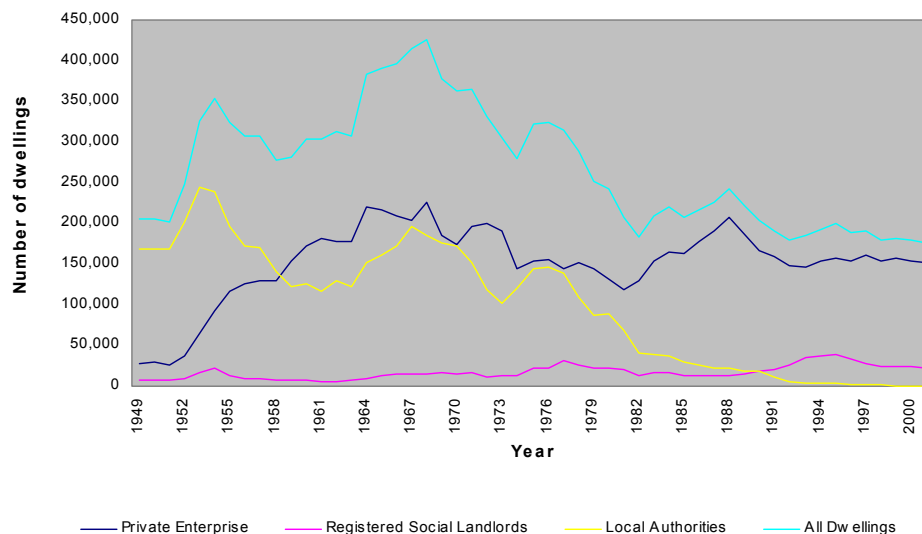
4. The aim of this submission is to look for features of the housing market that have become more restrictive than in the 1980s. Consequently, it does not address the questions of speculation (developers have always had incentives to smooth output and to speculate on land appreciation during upswings); national land constraints (Britain has always had a scarce supply of land; this hasn't changed in the last decade); industry constraints (capital requirements and skills needs haven't changed significantly in the last decade, although it is possible that there has been an increase in the concentration of large housebuilders); or the small size of the private rented sector (this has also been the case in Britain for along time). Instead, this submission examines the role of regional mismatch; the policy environment; and the social housing sector.

Evidence

5. In 1988, at the top of the previous housing cycle, 202 thousand permanent dwellings were completed in England, of which social housing accounted for 27 thousand and the private sector 175 thousand. In contrast, in 2002, at the top of the recent housing cycle, 139 thousand permanent dwellings were completed in England, of which social housing accounted for 14 thousand and the private sector 125 thousand.

6. Notably, during the 1980s upswing, the number of permanent dwellings completed by the private sector rose by around 30 per cent between 1985 and 1988. In contrast, between 1999 and 2002, the number of permanent dwellings completed by the private sector rose by only 2 per cent. This certainly suggests a much more attenuated private sector supply response. Moreover, social housing completions fell from a peak of 32 thousand in 1994 to only 14 thousand in 2002. Consequently, total completions in England actually fell by about 2 per cent between 1999 and 2002, that is, completions fell during a remarkably rapid upturn in the market! See Chart 1 (taken from the ODPM website):

Chart 1 Permanent dwellings completed by tenure, United Kingdom



Argument

7. This section presents three plausible reasons why the supply response might have been weaker in the 1990s upswing than in the 1980s upswing: regional mismatch, the policy environment, and social housing.

8. The data presented above are for the UK and England as a whole. However, it is well-known that the housing market is not a national market, and that there are important regional considerations. One striking aspect of the 1990s upswing compared with the 1980s upswing is a change in the pattern of migration around London. In a typical year in the 1980s, there was a net flow of around 50 thousand people leaving London, mostly settling in the South East, East Anglia or South West (see Muellbauer and Cameron, 1998). This trend continued in the 1990s, picking up to around 70 thousand people a year in the late 1990s. In contrast, while in the 1980s there was very little net international migration into London, by the late 1990s, net international migration into London was running at about 100 thousand people per year. As noted by GLA (2003), these migrants tended to be at either end of the income scale, rather than in the middle.

9. This change in migration patterns has considerable implications, both for the London housing market, and the national housing market. In the past, net out-migration from London tended to be offset by net population growth (London's population is relatively young compared with the rest of the UK). Consequently, there was little need for net housebuilding in London. In contrast, during the 1990s upswing, the net in-migration into London, coupled with a high net birth rate, placed considerable upward pressure on London house prices. Note that in the final quarter of 1988, London house prices for existing dwellings were 61% higher than the UK average. In contrast, in the final quarter of 2002, they were 76% higher.

10. Increased regional mismatch in the 1990s would not have mattered so much if the supply response had been adequate. However, this was not the case. Between 1985 and 1988, private house completions in London rose from 6.5 thousand to 13.0 thousand, an increase of 100 per cent, compared with a rise in South East housebuilding of 18 per cent and an English rise of around 30 per cent.

11. Between 1999 and 2002, private house completions in London rose from 9.5 thousand to 11.5 thousand, an increase of just over 20 per cent, compared with a rise in South East housebuilding of 2.4 per cent and an English rise of 1.2 per cent. Indeed, even after this relative rise in housebuilding, London's share of English housebuilding in 2002 was only 10 per cent, considerably less than its 15 per cent share of the English population.

12. Therefore, one possible explanation of the lack of supply response in the 1990s upswing is a greater regional mismatch between housing demand and potential housing supply. Compared with previous housing cycles, the 1990s upswing can be characterized as having been particularly concentrated in London, exactly the region of the UK where housebuilding is lowest given its population density.

13. Turning now to the policy environment, it is worth mentioning that there were a number of policy changes in the 1990s that may have altered the profitability of housebuilding, and hence affected the supply response. Arguably the most important of these policy changes was the introduction of Section 106 agreements in the Town & Country Planning Act 1990 (as amended by the Planning and Compensation Act 1991). Although not exhaustive, the kind of obligations that might be covered by such agreements includes the inclusion of affordable housing; provision of employment training schemes; provision of community facilities; recycling facilities; and extensions and improvements to the public transport system.

14. It is beyond the scope of this submission to review the implementation of Section 106 agreements and the operation of the planning system in general. However, it is possible to make a number of comments on their economic impact. One sensible purpose of Section 106 agreements and the planning system in general is to ameliorate the impact of developments on existing residents. Housebuilding clearly causes externalities such as increased congestion of local services, and the aim of the planning system should be to make the developers bear the full social marginal cost of their activities. A further sensible purpose might be to appropriate some of the ‘planning gain’ from any development for the public purse.¹

15. However, it is in the implementation of these two sensible purposes that problems arise. First, an economically efficient application of the externality principle should make developers bear the full social marginal cost of their activities, but no more. In contrast, Section 106 agreements are often interpreted by local authorities as an opportunity to *improve* the quality of the environment, rather than just hold it constant. This suggests that developers have to bear a charge greater than the full social marginal cost, and that consequently there will be too little development. For example, Islington (2003) states:

‘The broad principles of government policy are that the planning system should operate in the public interest, and should aim to foster sustainable development...in a way that *adds* to rather than detracts from the quality of the environment’ [Italics added]

16. Second, an economically efficient application of the planning-gain principle must be careful that only true economic profits are taxed (see GLA, 2001, for a discussion).² In practice, accounting profits are a very poor approximation to economic profits (for example, because they typically only include certain elements of the return on capital and because there are large fixed costs in development that are hard to apportion to any particular development). Any planning scheme that uses the estimated accounting profit that a developer might make from a development as the basis of planning-gain would therefore generally be over-estimating the economic profits, with a consequent negative effects on development. It seems likely that this effect will be larger for the smaller scale developments that can be supported in a city like London since there are considerable

¹ Planning gain is defined as the increase in value of land due to a change in planning permission for its use.

² Stamp Duty, to the extent that its economic incidence is borne by the developer, is an example of a tax that does not just bear upon economic profits, and hence will be distortionary. Stamp Duty, of course, rose considerably in the 1990s.

fixed costs for each development which means that profitability is very sensitive to small, additional costs.³

17. Lastly, there is the issue of social housing. As mentioned earlier, social housing completions fell from a peak of 32 thousand in 1994 to only 14 thousand in 2002. Indeed, by 2002, social housing completions represented only around 10 per cent of total completions. That is, as the upswing gathered pace during the mid to late 1990s, social housing completions were consistently falling!

Conclusion

18. This submission has discussed three main reasons why the supply response of housing was so weak in the late 1990s upswing. First, an increased regional mismatch between demand and supply, with much of the increased demand located in the South East and London, precisely where housebuilding is most difficult. Second, the changes in the policy environment in the 1990s which have reduced the expected private returns on any given development. Third, the counter-cyclical collapse of social housebuilding.

19. One sensible policy conclusion that can be drawn from this submission is that the planning system should be reformed to ensure that the private return to housebuilding is adequate across the whole range of site locations and sizes. First, while developers should bear the social marginal cost of development (that is, they should pay for the externalities that development causes), developers should not be held to ransom in order to pay for public goods that are more efficiently funded from the public purse. Second, given that the provision of affordable housing is presumably a public good, it is clearly likely to be underprovided by the market. The sensible solution is therefore to make Payments in Lieu to developers to provide affordable housing rather than to effectively tax developers in a way that distorts their incentives to develop sites. In particular, given the large fixed costs of any development, it is essential that site size thresholds are not lowered without careful consideration of the effect on incentives.

20. It is also possible that there have been changes in the industry structure in the 1990s that led to a weaker supply response. Given that the early 1990s recession led to a major shakeout in the insurance and estate agency sectors, it seems likely that there was an increase in concentration in the housebuilding industry at the same time.⁴ As is well known, a more concentrated industry will exhibit a smaller supply response to a price shock than a less concentrated one.

21. However, it is worth bearing in mind that even if the supply response was much greater, the housing market would still be highly cyclical. After all, in the peak year of 2002, around 140 thousand houses were built in the UK, while there were 1262 thousand transactions. Even a doubling of the supply response would not make much of a dent in a market where prices are rising at 25 per cent every year.

³ Site size thresholds vary, but in general, very small developments, of less than around 15 units, are exempt from Section 106.

⁴ Only limited data is available on concentration in the housebuilding industry. Calculations for this submission, based upon data in GLA (2002), suggest that the four-firm concentration ratio in UK housebuilding rose from 12.5% in 1995 to 19.7% in 1999.

22. Lastly, while this submission has focussed on those factors that led to a weaker supply response in the 1990s than in the 1980s, there are doubtless many other structural oddities in the housebuilding industry that might lead to low supply in general (for example, uncertainty and risk; lack of access to finance; the large number of very small firms; lack of institutional interest in the private rented sector; and skills shortages). However, many of those are likely to be standard features of the UK system of production, rather than actually representing specific market failures that a policymaker should sensibly address.

23. One area that might sensibly be examined, however, is the way that the tax and regulatory systems treat different types of property owners: there is hardly a level playing-field between private owners, buy-to-let landlords, private landlords, and institutional investors. At the moment, for example, institutional investors tend to incur the highest rates of stamp duty and the current VAT system tends to favour commercial over residential development. In addition, there is the problem of the different tax treatment of new build homes from conversions and brownfield developments. Addressing some of these issues, along with the planning system, might lead to a modest increase in housing supply responsiveness, with modest consequential benefits for macroeconomic stability.

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