

Why is homebuilding so depressed when residential property is such a one-way bet?*

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The residential property market is a paradox.

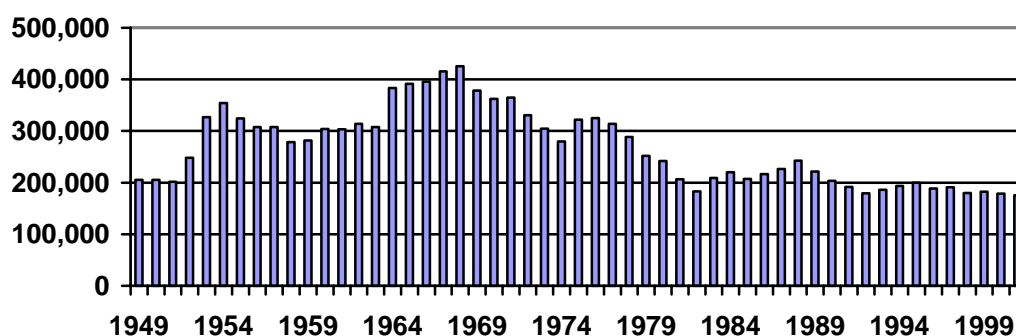
While house prices have risen exponentially matched only by growing demand, there have been record-breaking low levels of homebuilding. This contradiction reflects the failures of a poorly planned, over-regulated and under-resourced market. However, unless this apparent logic puzzle is solved, the consequences for future housing shortages will be dire.

The homebuilding paradox

Homebuilding at lowest level since the World War II

In 2001, homebuilding in the UK fell to the lowest level since 1948, before recovering slightly in 2002.

Permanent dwellings completed, UK



Source: ODPM Housing Statistics, Table 241.

The number of new homes in Great Britain completed in 2002 fell by a further 9.4 per cent to 146,000¹. The rate of building is now less than a third of that reached at the peak of the post-War reconstruction period².

* This paper has been written for the Joseph Rowntree Foundation's 'Easing Shortages of Housing' Policy and Practice Development Programme Advisory Group. It is based largely on research by cebr and published in the *Housing Futures 2023* report. The views and opinions expressed herein are those of the authors alone; they do not necessarily represent those of the Joseph Rowntree Foundation.

New housing now represents below 10 per cent of housing market transactions in England and Wales. This compares to 40 per cent in 1965.³

UK rates of homebuilding compare unfavourably to other developed countries – many with much lower rates of population growth. With the exception of Sweden, Italy and Denmark, the UK builds fewer new homes per head of population than any other member state of the European Union.⁴

250,000 new 'families' to be housed each year; 40% in the southeast

Meanwhile, demand for homes grows apace as a result of:

- natural population growth (albeit relatively slow)
 - lengthening life expectancy
 - immigration out-stripping emigration
- } **Increasing the population**
-
- changing family structures
 - increasingly dispersed networks of family and friends
 - higher personal expectations spurred by growing real incomes
- } **Reducing the average size of households**

Over the next two decades, an average of 250,000 new households will form each year.⁵ The size of the average household will fall from 2.4 people now to 2.1 by 2025; in 1981, it was 2.7.⁶

Forty per cent of these new households (which equates to 90,000 each year) look set to be created in London and southeast England, where housing shortages are already biting.

Three challenges: higher output; increased density; greater consistency

It is clear that, if the latent growth in demand for homes – both in terms of numbers and locations – is going to be anywhere near satiated, the building industry must deliver:

- *Higher rates of output*
- *Increased density / reduced footprints of dwellings*
- *More consistent performance year-in year-out*

But what is stopping this happening now?

There is no single explanation. Indeed, it is impossible – and would be facile – to distinguish symptom from cause. But a number of issues that need to be addressed if the three challenges are to be met can be identified. We highlight some of these below.

Challenge 1: Increase output

If the first challenge – increasing output – is to be met, the building industry needs the capacity to deliver around twice its current level of output, while planners and policymakers must ensure a business environment to encourage this activity.

Construction sector is already overstretched

The capacity of the construction industry is already overstretched – even with the current low levels of homebuilding.

On an irregular basis, the Department of Trade and Industry produces a review of the state of the construction industry in which they assess capacity and utilisation in the sector. Their latest reports provide grim reading:

“Despite steadily rising workloads in the second half of the 1990s and early 2000s, a shortage of key trade and professional skills has emerged. Therefore, a key question is how much capacity is left in the industry to carry on increasing its output.”

“The industry is struggling more to address its capacity shortages now, than it has done over previous periods of expansion.”

DTI, State of the Construction Industry, Spring 2002⁷

There is every indication that the sector is currently working at its limit⁸:

- recruitment difficulties in key trades; the proportion of unfilled vacancies to total notified vacancies increased from 36 per cent in October 1999 to 45 per cent in April 2001⁹
- manual workers’ earnings in the construction sector have risen to 12 per cent above the national average
- longer working hours

Meanwhile, the pressure on non-manual jobs is unlikely to improve over the coming years as the number of graduates with construction related degrees is expected to continue falling.¹⁰

While planning regime stifles competition and scares off serious investors

The planning regime is a significant constraint on homebuilding. The process of acquiring permission to build is complex, lengthy, costly and – all too often – apparently inconsistent and unpredictable. Few sectors suffer such direct state intervention and regulation. This environment does not encourage investors.

Meanwhile, the restrictions on land usage constrain the supply of sites available for development – and offer quasi-monopoly powers to those with existing land banks.

And absurd affordable housing rules are a punitive tax on development

To compound the difficulties, various policies that have been enacted to alleviate some of the deleterious outcomes of the housing shortage are exacerbating the underlying problems.

For example, the requirement for developers to include often-significant proportions of affordable housing is effectively levying a punitive tax on private investment. These requirements expose developer to three additional costs:

- reduced rates of return from affordable housing sales
- higher managerial costs and risks from negotiating with planners
- negative impact on branding of new developments targeted at higher income groups

Under-developed rental market exemplifies lack of investment

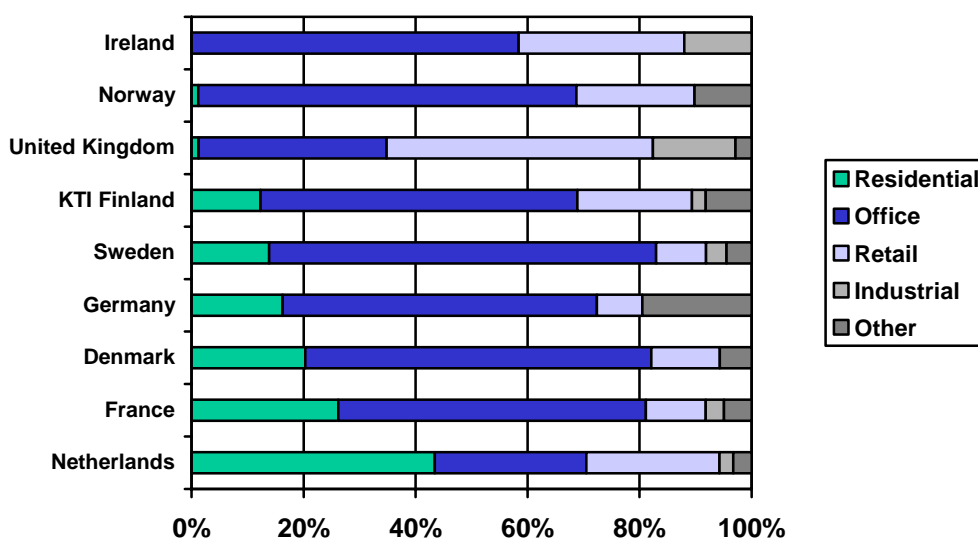
One of the clearest manifestations of the lack of concerted investment in the housing market is the weakness of the private rental market.

The comparison with Europe is stark.

Nine per cent of UK households rent their dwelling from private landlords. In Spain, the equivalent proportion is 13 per cent – even though a greater proportion of Spaniards own their own homes than Britons. In Italy and France, it is 21 per cent and, in Germany, it is 46 per cent.¹¹

But more telling is the extent to which professional property investment community in the UK ignores residential assets – especially in comparison to our European neighbours.

Proportion of capital value in IPD databanks, by country



Source: Jacqui Daly, *Sustainable Communities and residential Investment*

Challenge 2: Increase densities / reduce footprints

The second challenge is to increase the density of development, especially in those areas – southeast England and some of the provincial urban centres – where housing shortages are made even more acute by the lack of available developable land.

Reducing footprints doesn't necessarily mean less floorspace

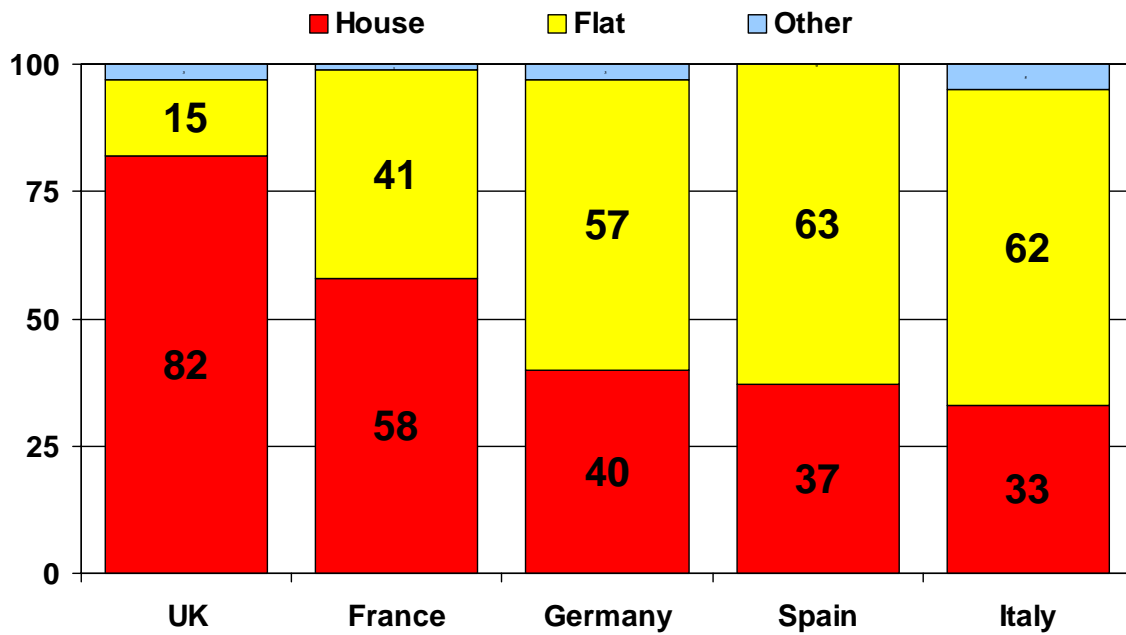
It is important, though, to dismiss a couple of misconceptions early on.

First, increasing the density of population and/or reducing the footprint of dwellings does not necessarily imply reducing the floorspace of homes. Although the UK has the highest proportion of houses (as opposed to flats) among our main continental rivals, we have the smallest homes. Moreover, typically on the continent, new build homes are bigger than the existing average, whereas here they are the same.

Smaller families but more clutter

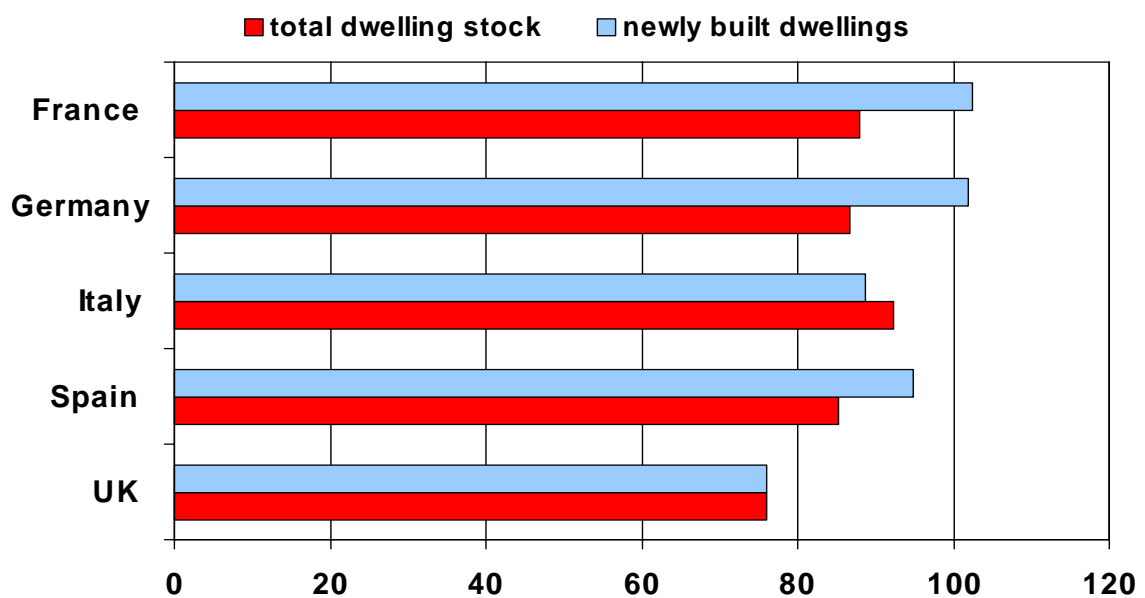
Second, although the average number of people per household is falling, this does not imply that demand is shifting significantly towards smaller dwellings. Two factors – growing real incomes/expectations and increasing number of possessions – suggest that the underlying demand is for greater floorspace per person.

Types of dwellings, 1996 (percentage)



Source: European Community Household Panel Survey (1996)

Average useable living space per dwelling (m²)



Sources: European Housing Forum; cebr calculations

New densities: new technologies...

If the challenge of higher densities is to be met, a technological shift is needed.

Whereas office development, retail construction and industrial building have improved productivity rates, the homebuilding sector appears to have been left behind.

New technologies, improved working practices and better project management lie behind many of the improvements elsewhere in the construction sector. There is a higher 'engineering and design content' to non-residential building. A substantial proportion of inputs are precision fabricated off-site and there is greater use of process engineering techniques to improve on-site efficiency. Standards of design have also improved to match the accelerating demands of businesses. And, there is more innovative use of materials (including timber, steel and concrete).

Homebuilders need to catch up.

These newer technologies can have a double benefit. First, they can facilitate improved rates of productivity – thus helping to increase output in an already constrained sector. Second, they make the job of increasing densities – by building higher or designing out wasted space – more manageable.

... require improved skills and flexibility ...

The newer technologies require new (and more specialist) skills and greater flexibility from the workforce. It is unclear, however, whether the existing industry is fit for this challenge.

There is plenty of anecdotal evidence to suggest the residential construction sector suffers from a poorly skilled and transient workforce – although there is scant statistical evidence to support this or any other view.

... but the sector has too few machine operators and professionals

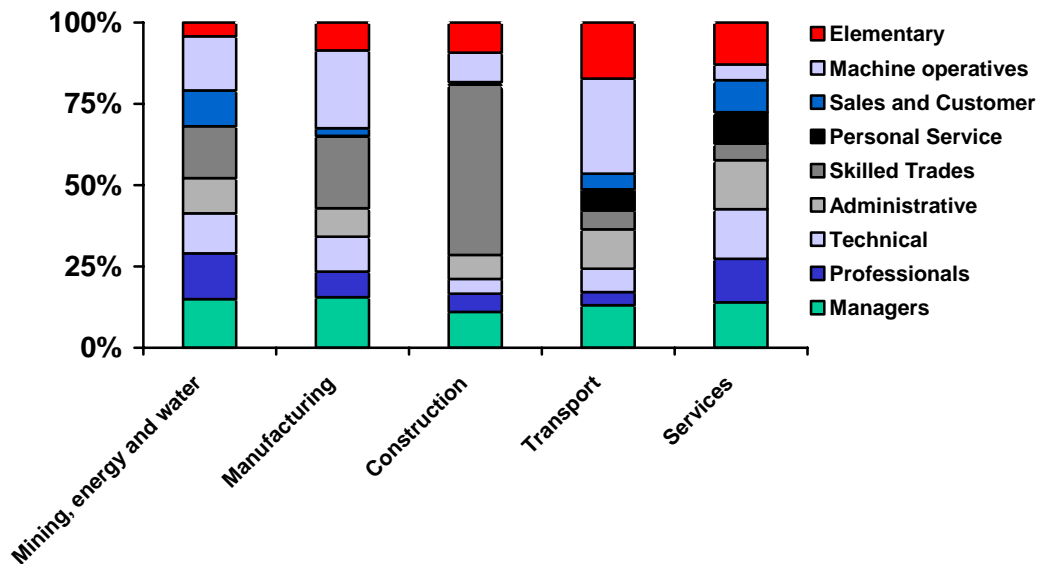
There are government data on the occupational structure of construction workers. On initial inspection, these data are encouraging. Over 52 per cent of construction workers are in 'skilled trades' – but this is largely a matter of (mis)definition and tells us little about the actual skill level.

Worryingly, there are relatively few 'machine operatives' in the construction sector. This is somewhat surprising given the rate of mechanisation in recent years. Further mechanisation – especially on site – will be critical to improving productivity and implementing new technologies.

Construction also has the lowest percentage of managerial, professional, technical and administrative occupations among the sectors. Together they comprise only 28 per cent of construction employees compared to 42 per cent in manufacturing and 37 per cent in transport. These

occupations are more typical of sectors with a higher knowledge, design and engineering content.

Occupational composition of workforce by sector, 2001 (percentage)



Source: National Statistics

... and trend in women's participation suggests inertia and inflexibility

There are also plenty of anecdotes to suggest the sector suffers inertia and inflexibility.

This is borne out by statistics on female participation rates. It isn't a surprise that fewer women work in construction than elsewhere in the economy (below 14 per cent compared with over 50 per cent). But this proportion is currently falling – from 19 per cent in 1995.¹²

And homeowners', banks' and planners' attitudes need to change

It's not just the builders that will have to adapt if higher densities are to be achieved.

First, there has to be **greater willingness among householders to live in high-density accommodation.**

Although the attitudes are eroding quickly (especially among younger urban dwellers), there remains a general presumption against multiple occupancy formats. This is partly the legacy of poorly designed and badly constructed high-rise social housing of the post-War era, which stigmatised many high-density formats. But 1960s' council flats aren't solely to blame. Occupiers of older private properties converted into flats are often blighted by noise intrusion and a lack of privacy. Moreover, many modern developments suffer similar afflictions as a result of inadequate build quality. These concerns are often compounded by the confusing legal position of flats.

Second, mortgage lenders will need to relax their attitudes to multiple occupancy dwellings. There remains a reluctance to lend on flats in blocks higher than around six or seven storeys – especially ex-council housing, and many lenders look unfavourably on certain legal statuses of ownership.

Third, planners will need to review restrictions on building heights and mass if they are to encourage imaginative new design solutions to the density conundrum.

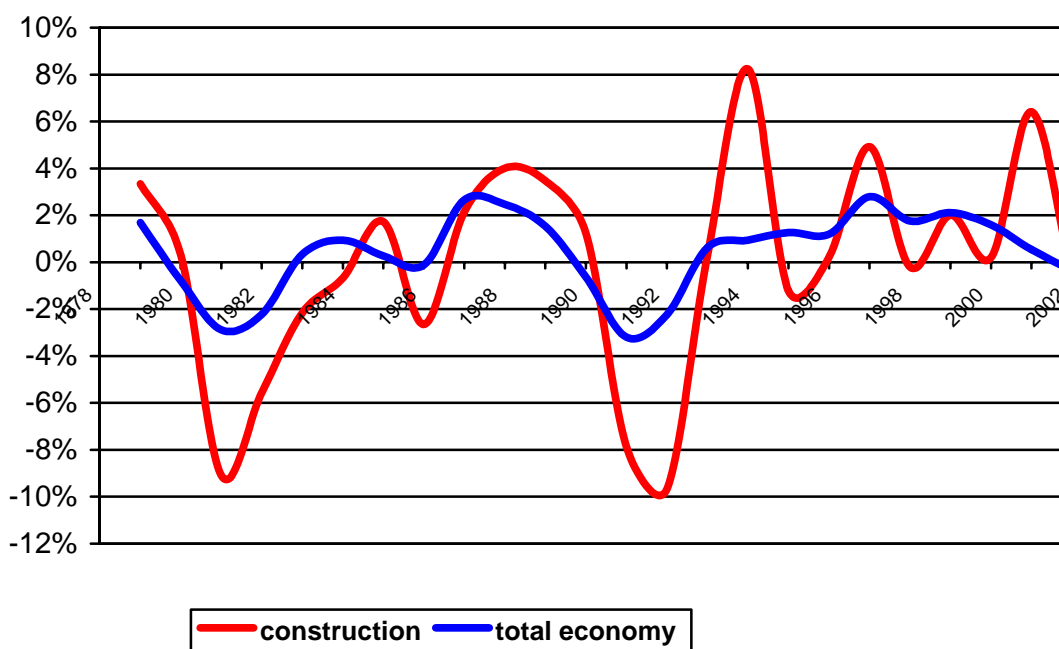
Challenge 3: Greater consistency / reduce volatility

The third challenge is to encourage greater consistency in the performance of housing output.

Construction characterised by big swings in output and employment

Construction – especially homebuilding – is a notoriously volatile sector with large swings in output (and employment) between years. This pattern is typical of a number of 'investment goods' but the cycle in the building industry is exaggerated – despite the underlying demand for housing being more robust and consistent than for many other investment goods.

Year-on-year change in number of employees



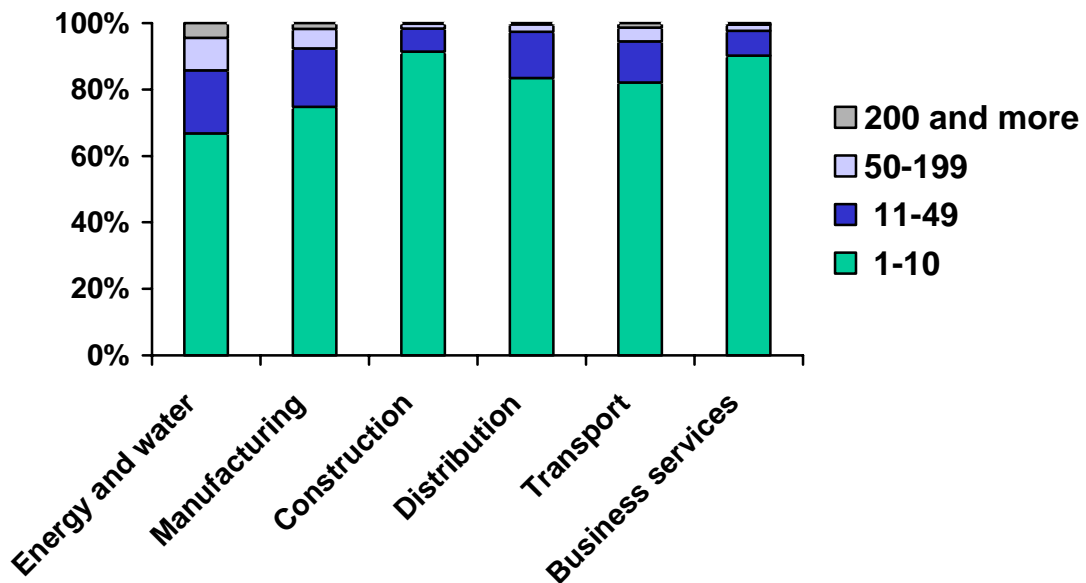
Sources: National Statistics; cebr calculations

Resulting from a fragmented industry

Underlying this volatility are highly fragmented – and under-resourced – residential property development and construction sectors.

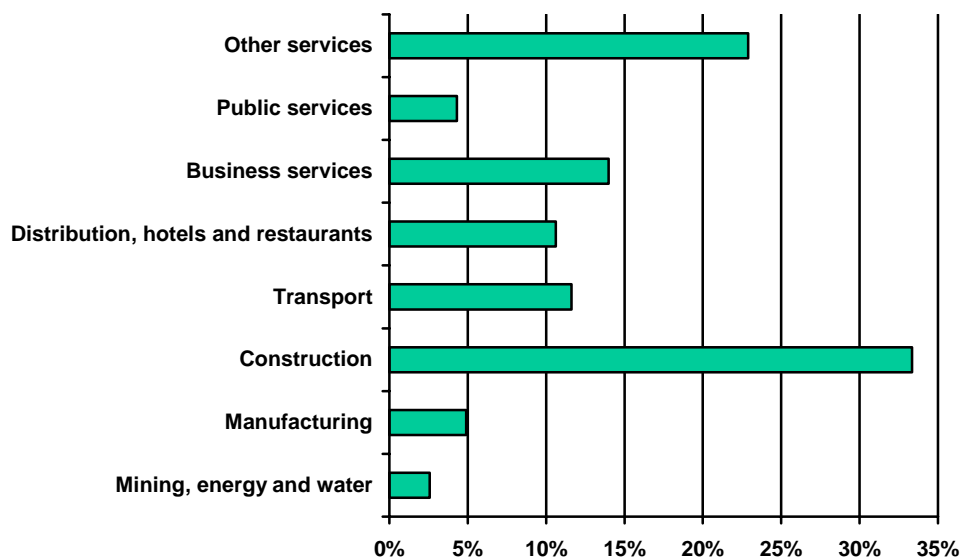
Only 1.6 per cent of VAT registered companies in the construction sector have 50 or more employees. In business services, the equivalent proportion is 2.3 per cent; distribution 2.6 per cent; transport 5.5 per cent; manufacturing 7.6 per cent; and 14.3 per cent in the energy and water.¹³ Moreover, a third of all workers in the construction sector are self-employed – over double the rate in almost every other sector.¹⁴

Share of VAT registered companies by number of employees, 2001



Source: Annual Business Inquiry 2001

Self employed as a share of total workforce by sector, 2001



Source: National Statistics

Firms too small to ride out the business cycle and invest in the future

The fragmentation of these sectors means that too few companies have either the balance sheet or the cash flow to make sufficiently long-term decisions that would allow them to ride out the business cycle. Meanwhile, their access to growth capital is inhibited by the reluctance of blue chip institutions to invest heavily in a sector which is so much at the whim of local politicians and officials, and whose managers lack the experience – and, some might argue, professionalism – of big company culture.

A vicious circle of over-regulation, under-funding and short-termism

It is, then, a vicious circle:

- (i) A poorly administered and over-regulated planning regime discourages investors.
- (ii) Without access to serious risk capital, the residential property industry is fragmented and under-funded (even though the long-term prospects are rosy), which exaggerates the business cycle rather than smoothing it out.
- (iii) Rather than looking to invest in the long-term, the focus of too many in the industry is keeping costs to a minimum to ensure short-term financial viability.
- (iv) The short-termism prompts excessive rates of out-sourcing, self-employment and staff turnover.
- (v) This environment inhibits the development of a solid skills base and discourages talent and professionalism. This all too often leads to inadequate design and build standards, and a lack of innovation.
- (vi) Poor standards prompt further regulation and state intervention, while investors are further discouraged by deficient management and business practice.

How can the vicious circle be broken?

The vicious circle has been established over many decades and is now entrenched. If it is to be broken, it needs to be attacked from all angles. We suggest some partial remedies that may be part of a potential package:

1. Make planning and building control more consistent, transparent, speedy and predictable, and reduce its costs. This probably means taking it out of the hands of local officialdom.

2. Encourage long-term residential property investment vehicles that provide growth capital to businesses willing to plan beyond the current cycle. These could be state supported – such as *small business investment companies* and development banks.
3. Review productivity in homebuilding, and assess what can be learned from best practice in other building sectors, manufacturing and engineering.
4. Abolish affordable housing requirements: subsidise families, not their homes.
5. Ensure building standards and planning regulations encourage technological innovation, and permit higher densities.
6. Encourage relevant vocational education at 16 and 18 (rather than funding 50 per cent of 18 year olds to read for a degree?)
7. Encourage management and professional training for incumbent managers in the sector – possibly through secondment schemes?
8. Penalise mortgage providers who price-out or refuse applications from purchasers of high-density formats / Support mortgage providers that do.
9. Build consumers' confidence in new build and new technology. Is the NHBC guarantee enough?
10. Work to promote more favourable public attitudes to high density: from *Only Fools and Horses* to *Friends*?

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¹ ODPM Housing Statistics (<http://www.odpm.gov.uk/housing/statistics>), Table 221.

² Homebuilding peaked in 1968 when completions reached 425,000 for the United Kingdom – ODPM Housing Statistics, Table 241.

³ ODPM Housing Statistics, Tables 244, 245, 532; cebr calculations.

4 ODPM Housing Statistics, Table 112.
5 From Housing Futures 2023, p.79: number of households in the UK will increase by 5 million
in 20 years.
6 Housing Futures 2023, p.78.
7 <http://www.dti.gov.uk/construction/stats/soi/soireport.htm>
8 <http://www.dti.gov.uk/construction/stats/soi/soiwinter0203.htm#10>
9 DTI Construction Statistics Annual, 2002, p.158.
10 <http://www.dti.gov.uk/construction/stats/soi/soiwinter0203.htm#10>
11 INSEE, L'Observatoire de l'Épargne Européenne, National Statistics
12 <http://www.nomisweb.co.uk>
13 Annual Business Inquiry 2001
14 <http://www.nomisweb.co.uk>