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Market-led housing supply and the lure of demand stimulants in the UK

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Since the 1970s, the UK has become dependent on speculative private developers for the large majority of its housebuilding. There is a widespread consensus that output has failed to keep up with need for most of this period, and real house prices have risen rapidly since the mid 1990s in particular. There are various factors that have contributed to what is widely regarded today as the 'housing crisis', but among them is a market-led housing delivery model that relies on ever-rising effective demand. When prices fall in response to an external demand shock, output is cut back; but when prices rise, output remains insufficient to significantly reduce them. Meanwhile, purchasing power in the housing market – particularly by way of mortgage finance – has increased many times over during the same period. Housebuilders and governments have welcomed this as, in the short term, it supports higher output. But in the longer run, higher demand is priced into development values, meaning that purchasing power must be maintained indefinitely if private-sector housebuilding is to be maintained. Owing to their reliance on market-led supply, governments are now in the perverse position of trying to maintain, and even increase, historically unprecedented levels of demand – even though that demand is responsible for the high house prices they are ostensibly trying to tackle.

In October 2017 the UK prime minister, Theresa May, promised to dedicate the rest of her time in office to fixing the country's 'broken housing market'.

> For 30 or 40 years we simply haven't built enough homes. As a result, prices have risen so much that the average home now costs almost eight times average earnings, and that's been a disaster for young people in particular. (May, 2017)

The priority placed on housebuilding by May reflected an emerging sense in Westminster that housing policy in recent decades had failed and that a new approach was required. Two events in June 2017 had pushed housing to the front of politicians' minds. The first was the result of that month's general election, in which May failed to obtain the parliamentary majority she had been expecting, blamed by many on the Conservative Party's limited appeal to young people increasingly shut out of home ownership. The second was the Grenfell Tower inferno, which provided an appalling reminder from the heart of the country's richest borough, Kensington and Chelsea, of the long-term neglect of social housing. Addressing the Conservative Party conference in October 2017, May announced that the government would be supporting a new generation of council housebuilding. The shift in emphasis was a small landmark in Conservative housing policy, although for the time being the sums committed have remained modest.

To understand what has gone wrong over the past thirty or forty years, and the symbolic significance of this policy change, it is helpful to place it in historical context. UK housing policy has evolved through three distinct periods over the past century or so. The first was the laissez-faire approach of the nineteenth century, when housebuilding was left almost entirely to speculative builders who responded to nothing more than the profitable opportunities on offer from the construction of new dwellings; they mostly purchased plots of land in areas of population growth where they had some confidence of being able to sell them on to landlords, who earned their capital investments back in rent over the following years. The end of the First World War ushered in the second phase of policy, which was characterised by large-scale council building programmes as a complement to the speculative industry. This approach lasted for about half a century, from the years immediately following the armistice in 1918 until the 1970s; during this period housebuilding output reached record levels

and house prices were mostly stable, if punctuated by the upheaval of the Second World War. The third phase witnessed a partial return to the pre-1914 approach and the reliance on the private sector. From the 1970s, council housebuilding was steadily scaled back until, during the New Labour years (1997–2010), annual local-authority output numbered in the low hundreds. Reduced levels of housebuilding subsidies were channelled principally through housing associations from the 1980s onwards, but their output was never more than a fraction (usually in the range of 20,000–30,000 homes a year) of that of the former local-authority programmes.

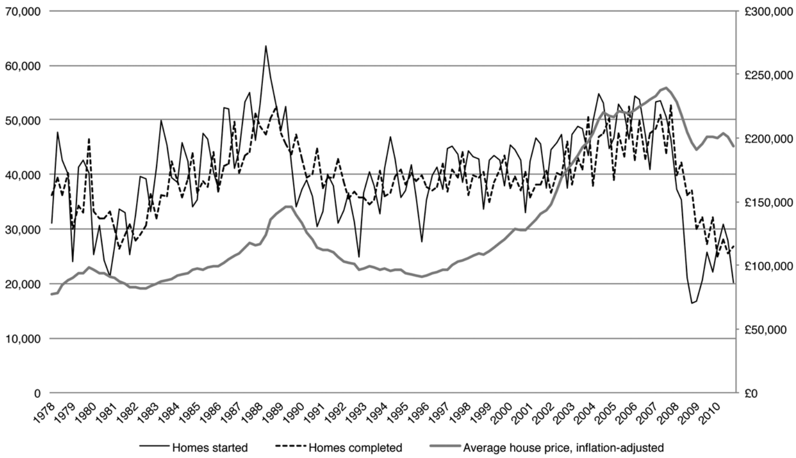
For the past half-century, then, housing supply has been dominated once more by the speculative builder, albeit since the early 1990s increasingly in the guise of the publicly listed volume developer. This third period of housing supply policy has corresponded with a series of increasingly pronounced house price booms and busts. The most recent and most dramatic of these booms, dating from the mid 1990s, has so far not been reversed; the financial crisis prompted a small correction which, a decade later, has turned out to be little more than a wobble. After more than two decades of surging prices, they are now five times higher in real terms than in 1970. The OECD estimates UK house prices to be 21.3 per cent overvalued on the basis of their long-run relationship with incomes (OECD, 2017).

The precise determinants of this price growth are not widely agreed upon, although there has been a strong (if not complete) consensus for many years that too few homes have been built (Barker, 2004; Lyons Housing Review, 2014). The housebuilding industry has consistently blamed this on the discretionary, and therefore restrictive, nature of the planning system, perhaps the only vestige of social democratic housing policy to survive the post-1970s market turn. This is supported by various studies showing evidence of a relationship between house price inflation and planning restrictions (Cheshire, 2014; Hilber & Vermeulen, 2015). But these interpretations tend to ignore a variety of factors influencing housebuilding levels, and in particular the inherent challenges facing market-led housing supply.

To start at the most basic level, the private-sector builder can only build what customers are willing and able to buy. This means that, in the absence of countercyclical public investment when supply subsidies are low and fixed, total housing output in any given year is ultimately determined by the strength of the market for new-build homes. As a result, and as Figure 1 shows, housebuilding activity is highly sensitive to movements in prices. Increases in output tend to

track periods of sustained price inflation. When prices fall, output is cut back. Price shocks in the early 1980s, the early 1990s and the late 2000s all prefigured a sharp reduction in starts, and what is usually a gentler fall in completions. This presents an obvious challenge to any attempt to improve house price affordability that relies on an increase in private-sector supply.

Figure 1: Private enterprise starts and completions (quarterly) vs average real house prices, UK



Source: Department for Communities and Local Government; Nationwide.

There are two interconnected difficulties here. The first is that housing supply is not driven by the need for housing but by capricious economic demand; it is mostly unresponsive to the underlying need for shelter. The second is that, even when market conditions are benign, supply rarely exerts strong downward pressure on prices. Private-sector output responds to the desire of customers to buy new-build homes but they must also be able to do so at current prices or above. As affordability becomes increasingly stretched, that presents a supply constraint.

This is a function of residual land pricing, which means that the value of the land is equal to the surplus that is generated from selling newly built homes after construction costs (materials and labour) and the developer's profit margin (usually about 20 per cent). In bidding for the land, developers must assume that the homes they plan to build will be sold at current market prices or above; the developer that does

not will be outbid by others that will. This means that the minimum price of new-build homes is set when the purchase of the land is agreed, long before they are built, and if circumstances force those assumptions to be revised downwards, the developer stands to make a loss. Herein lies the problem.

When the market weakens and house prices fall, schemes under way or about to get under way become unprofitable for the developer. Unable to sell homes at the rate and at the price they envisaged when they purchased the land, developers face what they call 'viability' constraints and sites become stalled. The economic downturn that followed the financial crisis of 2007/8, for instance, resulted in a large number of schemes being put on hold. In July 2012 there were 1,331 stalled sites, containing 71,821 potential housing units, that had planning permission and were technically 'shovel ready', but were not being implemented. McAllister et al. (2013) found that there was a combination of factors influencing whether sites were being implemented or not, but concluded, 'Changed market conditions are the key reason for sites becoming stalled.'

Not only do existing sites become unprofitable, but new residential land may not be forthcoming while prices are depressed, as landowners become unwilling to reduce the price they expect to receive for their land, and exercise 'their options to delay the sale of their sites'. The response to this scenario from David Cameron's coalition government, as it grew increasingly desperate in the early 2010s to kickstart housebuilding from its post-crash low levels, was to improve the financial viability of schemes for developers. It did this by way of direct financial subsidy (offering to pay for infrastructure costs, for example) and by pressuring local authorities to reopen Section 106 agreements, which are the principal tool available to councils for negotiating developer contributions towards affordable housing and infrastructure as a condition of being granted planning approval. By reducing previously agreed Section 106 obligations, the profit margin – and therefore the viability of the scheme – was improved. The cost of increasing housing output in this way was to sacrifice sub-market housing provision even while the affordability of market provision was worsening.

When the market is stable or rising, output rises, but only conservatively. Because land for new residential development is valued according to the price of the homes that are to be built on it, and because those homes are priced from the start at the limits of what the market can bear, the process of selling them has to be a patient

one. Developments of any size cannot be built as quickly as they technically could be, because there are not enough buyers at the prices required. The Office of Fair Trading described this as follows:

> build-out rates, or absorption rates as they are known… are dictated by local market conditions and not by the maximum technical speed at which homes can be built. Homebuilders deliver new homes as fast as they can sell them, not as fast as they can build them. (Office of Fair Trading, 2008)

This means build-out rates of 50–100 homes a year are common. According to a 2016 study, sites of between 100 and 499 units would deliver, on average, 60 units a year; a very large site of 2,000 units or above would still only deliver about 160 a year. Brownfield sites are built considerably more slowly on average than greenfield, however, with those of 500–999 homes being built at a rate of 52 per year, sites of 1,000–1,499 at 73 a year and sites of 1,500–1,999 at 84 a year. A 1,500-unit brownfield site, then, would take more than 17 years to complete from the point at which construction starts (Nathaniel Lichfield and Partners, 2016).

It is frequently suggested that developers have a financial incentive to restrict supply in order to push up prices, with the implication that they are creating artificial scarcity. It is a claim they vociferously deny. But at best they are building and selling the homes no faster than the rate at which customers can purchase new-builds at the price that is a corollary of the land value. While developers reject the accusation that they are trying to control the land price, they are candid about the fact that they cannot sell homes at prices lower than those on which they based their bid for the land. Giving evidence to a House of Commons Select Committee inquiry into housebuilding in 2016, Peter Redfern, chief executive of volume builder Taylor Wimpey, told MPs:

> Clearly, we are not looking to drive down the market price, having bought a piece of land, but we are price-takers, not price-setters. We are not looking to control the price and we never have been, either locally or nationally. There is no attempt from the industry to restrict supply, but we are absorbing what demand we can find in the local areas where we have sites, at more or less the market price. That is because that is the financial case on which we have bought the land in the first place. (Redfern, 2016)

David Thomas, group chief executive of Barratt Developments, added:

> We are clearly not incentivised to sell at below market price. That is not the basis on which we bought the land. If we bought the land on the basis of a below-market-price, that would be a different thing. (Thomas, 2016)

It is worth noting that, while the housebuilders receive a lot of criticism for this situation, the biggest beneficiaries of all are landowners. Because current house prices are capitalised into land prices before development even starts, the landowner walks away with the windfall (a profit that might be 100 times the value of the land in its agricultural state), no matter what then happens to the site; the developer is at least bearing the risk as they then seek to pass the cost of the land on to the buyers of new homes. Inevitably, housebuilding only proceeds at the pace necessary for the developer to achieve that. This creates a positive feedback loop in which high house prices require slow build rates, and slow build rates maintain high house prices:

> Falls in house prices can leave developers with assets that cannot be developed profitably, which results in a collapse in housebuilding until prices rise. But when house prices do rise there is little incentive to increase supply in an attempt to avoid future falls. The result is a vicious circle in which high land prices ensure housing output remains low and house prices high – which, in turn, sustains higher land prices. (Aubrey, 2016)

These difficulties would have been familiar pre 1914, when housebuilding was virtually all private enterprise. Building increased when demand was high, stimulated by low interest rates. When interest rates rose, housing became less attractive as an investment and prices fell; so too did output. Underlying problems with overcrowding and slum conditions were left unresolved. It was the realisation in the years before the First World War that speculative housebuilding would not solve ‘the housing question’ that led late-Victorian and Edwardian politicians to embrace the solution of public subsidies for housing provision. In 1914 the then chancellor David Lloyd George told MPs, ‘You cannot provide houses in this country by private enterprise’ (Lloyd George, 1914). When the war ended, his

promise to the returning soldiers and their families was 'homes fit for heroes' and the first substantial local authority building programmes. Between 1921 and 1939, publicly funded housebuilding averaged about 70,000 a year; between 1948 and 1979, it did not drop below 100,000 a year (Bentley, 2016).

With the partial return to market-led housing supply since the 1970s (still roughly 20 per cent of new homes have been subsidised for most of this time), there has been one major difference with the pre-1914 period: the steady amplification of demand over a long period of time. Because the supply of new homes is so dependent on the buoyancy of the market, successive governments have welcomed increases in purchasing power that provide a fillip to housebuilding output – despite the fact that higher levels of demand are quickly priced into future house (and land) values, so the benefit in raising output levels is a short-term one which only raises the affordability bar for buyers in the medium to long term. Once introduced, each new demand stimulant must then be maintained and, if the goal is to increase market-led housing construction without resort to direct public subsidies, then the political pressure builds for a further stimulant, and so on. This process has not always been by design or with direct reference to the housing market, but the effect has been no less for that.

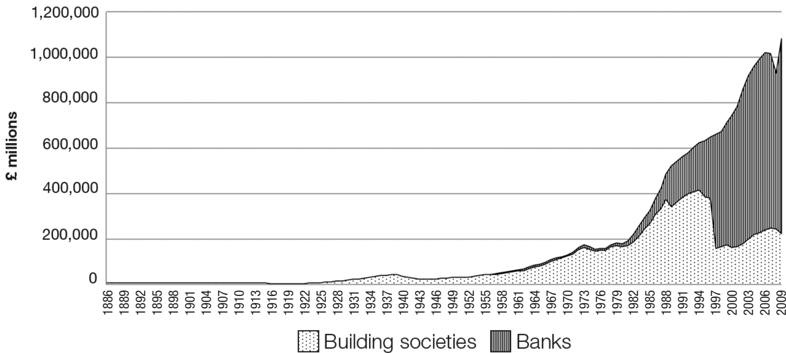
Of all of these stimulants, the liberalisation of the credit market since the 1970s has been by far the most significant. In an incremental process starting in 1971 with Competition and Credit Control (or 'all competition and no control' as it was quickly dubbed), quantitative ceilings on lending were removed, the mortgage market was thrown open to the banks and the building societies were demutualised, abandoning their previously conservative lending practices along the way. It is difficult to overstate the significance of the shift in housing finance during this period, from a system in which mortgage lending was limited to the sums that had been deposited in building societies by savers, to one in which mortgage lending was provided by banks whose ability to generate credit is technically limitless. Borrowing to fund house purchases had been, until the 1970s, restricted to what had been earned in the economy already and withdrawn from consumption; since then, it has been limited only by the banks' confidence in lenders' ability to repay loans out of future incomes.

This fundamental shift in housing finance was joined by innovations such as higher loan-to-value lending from the 1980s and, from the

early 1990s, a sharp decline in interest rates, the principal tool available to the Bank of England to control lending, and so prices. The irony of the most recent house price boom, starting in the 1990s, was that it was in part the product of a policy of inflation targeting and the pursuit of price stability, which was to be achieved by raising or lowering interest rates as a way of influencing new borrowing in the economy. But asset prices, including house prices, were not included in the inflation target, and so while the purchase price of a home drifted away from average earnings, interest rates were kept low, mortgage borrowing continued to grow and house prices increased still further. In all, mortgage lending increased seven-fold, in real terms, between 1970 and 2007 (Figure 2), setting up what Offer (2013) calls the 'property windfall economy'.

A significant portion of this borrowing was undertaken by a new generation of landlord-investors following the deregulation of the private rented sector at the end of the 1980s. Many of these were taking advantage of new buy-to-let mortgages, introduced for the first time in 1996, and were lured by the prospect of increasingly lucrative capital gains in a housing market that only ever seemed to rise. By 2011 there were 1.39 million buy-to-let mortgages outstanding, worth a combined £159 billion; twenty years earlier these mortgages did not even exist. Between 2001 and 2014/15 the number of homes owned by private landlords in England more than doubled, from 1.9 million to 4.3 million.

Figure 2: Mortgage lending by banks and building societies, 1886–2009 (2016 prices)



Source: Bank of England (2017).

This financialisation of housing met with very little resistance for many years, given that it increased house prices for those who had purchased homes already, a large voting bloc. But for future generations it has increased the amount of debt they need to take on in order to make their own purchases. It has also driven land prices to levels that are a barrier to entry to smaller builders, reducing competition and diversity of provision from the construction sector, while also increasing the risks for volume builders, and so reinforcing cautious behaviour.

The dilemma now, however, is where to go from here. A generation has been shut out of home ownership by high prices, but any significant correction in prices is likely to have macroeconomic implications. Mervyn King, the former governor of the Bank of England, warns of the risk posed by a fall in asset prices as interest rates 'return to normal levels', prompting the write-down of investment values by the banks and a wave of household bankruptcies (King, 2016). From a housing perspective, the constant dilemma that a fall in prices means a fall in housebuilding also reappears. For housebuilders, having built up several years' supply of land at values predicated on current house prices, a decline in purchasing power and a fall in prices are to be avoided at all costs. During his appearance before MPs, David Thomas of Barratt stressed the need for strong mortgage availability, even while acknowledging that higher leveraging by buyers had resulted in price inflation over recent decades:

> Mortgage availability is unquestionably our biggest concern. Mortgage availability, or the absence of mortgage availability, has tended to be a precursor to a downturn in the market… We have lots of other risks… but really the mortgage availability is our big, big concern. It has been the big challenge for the industry. If you go back to the 1960s, the availability of high loan-to-value was fundamentally different. There just was not the availability of high loan-to-values that there are now. But the reality is that we are in a high loan-to-value environment. Back in the 1960s, there was limited high loan-to-value availability and significant housing output, which was accompanied by relatively little house price inflation. It is not surprising that, if you are in a high loan-to-value environment and you do not have significant housing output, you will create house price inflation. Hence, in the vast majority of the last 30 or 40 years, we have seen relatively high house price inflation in real terms. (Thomas, 2016)

The housebuilding industry's reliance on buyers with access to historically unprecedented amounts of mortgage finance posed problems in the years after the great financial crisis when banks imposed tighter controls on borrowing. The response from the government in 2013 was 'Help to Buy', a scheme which offered mortgage guarantees and even taxpayer-funded equity loans to top up what commercial lenders were prepared to offer in the new credit environment. This provided government loans worth up to 20 per cent of the value of a new-build property (or 40 per cent in London). This gave housebuilders a boost as output has increased by about a third since then, with 112,000 new homes purchased with £5.3 billion of Help to Buy money by the end of 2016.

This has helped disguise the reality of a housing market stretched to its limit, however. Underneath these headline figures, little has improved. Strip out the new-builds purchased with Help to Buy and the housebuilding numbers have hardly moved since it was introduced. Neither has the scheme arrested the decline in home-ownership. While 90,000 first-time buyers have benefited from the scheme, more than half a million households have moved into the private rented sector during the same period and the proportion of households that are owner-occupied has now dropped below 63 per cent for the first time since the 1980s. The reality is that most would-be buyers cannot afford a home even with Help to Buy support. But now the scheme has bedded in, it is becoming increasingly difficult to withdraw, for all the same reasons as relaxed mortgage lending. Developers say that output would have been lower without it, and will be lower in future without it, too. David O'Leary, director of policy at the Home Builders Federation, says, 'With well over 100,000 sales, it has probably been the biggest determinant of the increases in output we have seen. It will be difficult to switch it off when it is such a big part of what the industry has been doing… it's a key part of the sales environment' (Evans, 2017).

Conclusion

While new housing supply has, since the 1970s, become largely dependent once more on speculative market-led output, marking a partial return to the laissez-faire approach familiar pre 1914, there are important differences. The discretionary planning system introduced in the 1940s remains, for instance, while housing benefit support for low-earners who cannot afford to pay market rents has reached about

£25 billion a year. Each of these interventions have, in their way, supported prices that are now unaffordable to many would-be first-time buyers today. But the biggest difference between then and now has been the decades-long expansion in mortgage lending, supported by an era of historically low interest rates, which has enabled house prices to reach unprecedented levels. This has created a dilemma for policymakers. They face, on the one hand, an increasingly vocal constituency of younger voters who have been priced out of the housing market and, on the other, a more influential bloc (for now) of older home-owning voters whose property values they are loath to undermine. Moreover, their continued reliance on market-led supply creates a further dilemma in that any intervention that reduces prices would result in a fall in housebuilding output. There are signs that all of the main parties – most recently the Conservatives – are now coming around to the idea that public subsidy for supply may have to be stepped up once more. But the lure of demand stimulants is always strong. When May announced the return of council housing last October, it was accompanied by funding of just £2 billion extra for the affordable homes budget, taking it to a grand total of £9 billion across the current parliament. Yet a few days earlier, the chancellor, Philip Hammond, had announced that the Help to Buy budget would be topped up by an additional £10 billion over the same period. Even as ministers proclaimed a new direction in housing policy, the temptation of giving an extra fillip to purchasing power was too great – even though that purchasing power is responsible for the high house prices they are ostensibly trying to tackle.

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