GLA ECONOMICS

Market failure and the London housing market

May 2003

Transport for London

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Greater London Authority
May 2003

Published by
Greater London Authority
City Hall
The Queen's Walk
London SE1 2AA
www.london.gov.uk
enquiries 020 7983 4000
minicom 020 7983 4458

ISBN 1 85261 484 6

This publication is printed on recycled paper

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Commissioned by GLA Economics

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Introduction

The market for housing is highly complex…

London is a city of over three million dwellings. Its stock of housing is made up of a wide variety of different types – flats, houses, maisonettes, bungalows – and of tenures – owner occupied, shared ownership, privately rented, socially rented. Its stock is relatively old – the majority of London's housing having been built before the Second World War. Indeed, the market for the purchase of property is almost entirely a second hand one – the amount of newly built housing in London in any one year represents a tiny proportion of the total stock (less than half a per cent).

London is also a very varied city – when you buy a property you are also buying its location in terms of the quality of its immediate environment, access to public transport and local services.

…and unique

For most people the purchase of a property is a highly infrequent activity. It is generally the most expensive purchase an individual will make during their lifetime and therefore entails borrowing a large sum of money. As a consequence the market for housing is inextricably connected to the market for finance – rates of interest play an important role. In addition, unlike most purchases people in London make, prices are to a certain extent negotiated.

Yet properties, as well as being places to live, are also seen as investments. In recent times house prices have increased rapidly, performing better than equity markets. However, as recently as the beginning of the 1990s the market witnessed falling prices with some house owners experiencing negative equity.

All these factors and others contribute to making the London housing market a highly complex and unique entity.

Market failure is endemic

It is also a market that in certain ways and at certain times fails to satisfy the needs of residents. It sometimes fails to meet the minimum standards our society sets for a decent home and fails to produce an efficient quantity of housing. The implications of these failures are serious, profoundly affecting the London economy and the well being of its people. The consequences include families living in sub-standard accommodation, homelessness, key public sector workers unable to afford to live near to where they work, and private companies unable to recruit the staff that they need to function effectively.

Market failure and inefficiency in the housing market has been described as endemic by one of the key contributors to the study of the economics of housing, Duncan Maclennan[1]. It makes theorising about the housing market very difficult and provides the reason for the need for government intervention in the market.

This is why there is a need for government intervention in the housing market.

[1] Maclennan, D. (1982)

Governments in all developed countries intervene in the housing market and do so in a variety of ways. Intervention takes the form of subsidies, taxes, direct provision and a range of regulation, in order to influence prices, levels of house building and the allocation of housing.

Whilst in the UK the vast majority of housing is market oriented – over 80 per cent of dwellings are bought and sold on the open market – the social sector plays a vital role, providing accommodation on the basis of need through local authorities and increasingly through housing associations or registered social landlords (RSLs).

This report provides an overview of the London housing market…
This report provides an overview of the London housing market from an economist's perspective. It looks at the fundamental processes that drive the supply and demand for housing, at the ways in which the market fails and the ways in which government intervenes.

…and focuses on the underlying economic issues behind house price bubbles, the under-supply of housing and the particular crisis in affordable housing
It focuses in particular on the economic issues underlying three of the substantial issues that currently face the London housing market:

- The cyclical nature of the housing market and how over inflated expectations can result in over inflated house prices, or house price bubbles.
- The endemic under-supply of housing that has been experienced in London and the South East over recent decades.
- The current crisis in the shortage of affordable housing in the capital.

First, however, this report looks at recent trends in UK and London house prices, which provide the backdrop for the subsequent discussion of the main housing market issues.

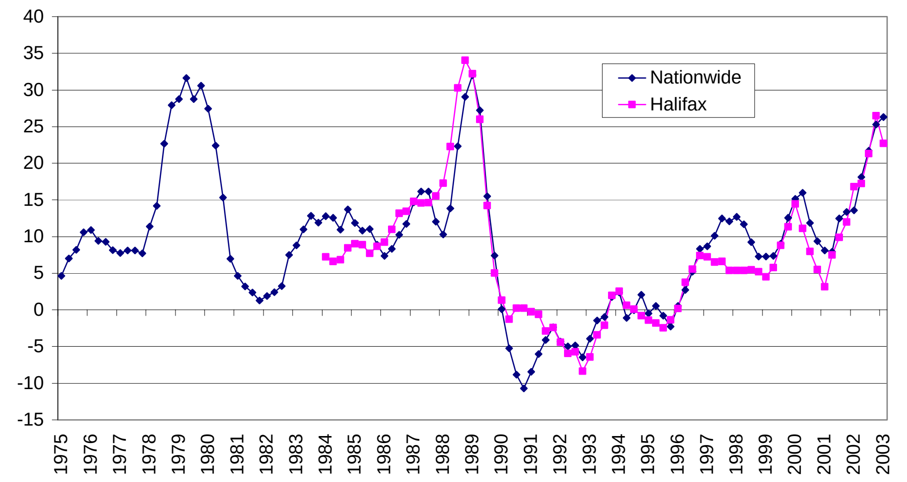
1. Recent trends in house prices

1.1 The UK house price boom

The UK has been experiencing a major house price boom

The past seven years have seen strong and escalating house price growth in the UK, a house price boom stronger than in any other major world economy. Growth rates did not quite reach those experienced in the previous two major UK house price booms in 1978/79 and 1988, but they were not too far behind.

Figure 1.1: House prices – UK
(% year on year change in quarterly house prices)



Source: Nationwide & Halifax

2002 saw the fastest rate of house price growth since 1989

According to the Nationwide, 2002 saw the fastest rates of UK house price growth since 1989, with prices rising by an average of £65 per day. Indeed data from both Nationwide and Halifax shows that by the final quarter of 2002 annual average house price growth rates had exceeded 25 per cent.

Low interest rates and shortages of property have been driving house price inflation…

The context for this recent period of house price growth has been one of low interest rates (indeed they are now at their lowest levels since 1955) and expectations that a low interest rate environment will continue. Average earnings have continued to increase with employment generally stable and unemployment falling. In combination these factors have provided a positive environment for housing investment.

Underlying this is the well-documented growth in household numbers in London and the South East, which has not been matched by increased housing supply, resulting in a real shortage of property for sale in London and the South East. The factors influencing supply and demand in the housing market are the subject of Chapter 2.

…yet such high rates of growth have been widely believed to be unsustainable
There has been a general consensus amongst commentators that house prices growth rates have been unsustainable over the medium term for some time. Most have been forecasting an imminent slowdown in house price growth since the summer of 2001. As a consequence there has been increasing speculation as to whether expectations of continuing house price rises have created a price bubble, boosting prices higher than justified by trends in the fundamental drivers of demand. These issues are discussed in detail in Chapter 3.

The Bank of England MPC felt able to cut interest rates…
On 6 February 2003 the Monetary Policy Committee (MPC) of the Bank of England announced a quarter per cent cut in the bank's repo rate to 3.75 per cent. Many economic commentators were surprised at the timing of the cut and some concern was expressed in relation to the impact of the cut on an already booming housing market.

Yet the MPC attitude towards house price inflation was made clear in the Bank of England's February 2003 Inflation Report. It pointed to early indications of a slowdown in growth in housing market activity towards the end of 2002 and into 2003, and stated that the Committee expects house price inflation to slow further.

…and there are now clear indications of a slow down in house price growth
Evidence cited in the Inflation Report was far from conclusive, however indications from the first four months of 2003 are that a slowdown is finally coming to pass. Whilst house prices in some regions of the country (mostly in the North) are still rising rapidly, most house price indices are now indicating that average house price growth in the UK has finally peaked (at least for the present).

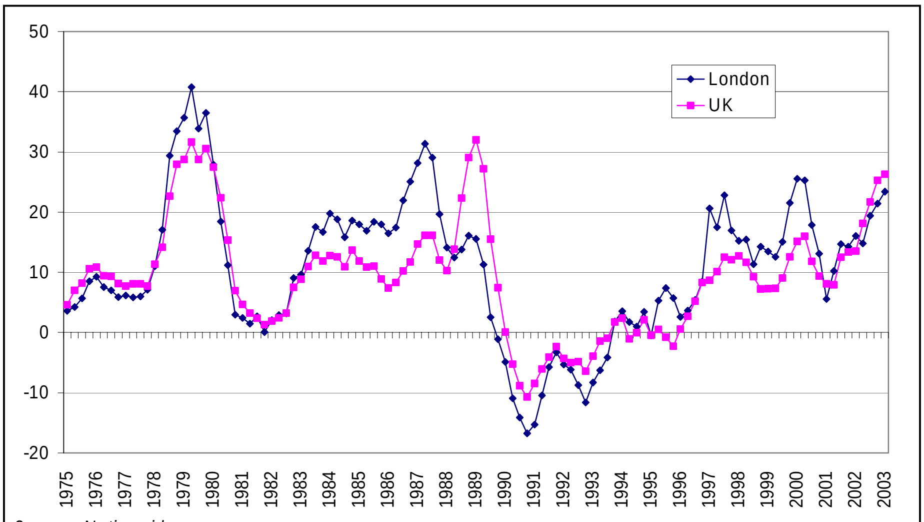
1.2 London house prices

London house prices rose faster than the UK average from 1995 to the beginning of 2002…
From 1995 to the beginning of 2002, London average house prices rose at a significantly faster rate than the UK average. According to data from the Nationwide, London house prices rose by 149 per cent from the first quarter of 1995 to the first quarter of 2002, compared to 87 per cent across the whole of the UK.

…but have now fallen behind
Annual growth rates in London dipped below the UK average in the first quarter of 2002, a trend that continues. Overall, however, since the mid 1990s London house prices have risen much faster than elsewhere in the UK.

Movements in London house prices have tended to exceed and anticipate those across the rest of the UK
Historically there has been a tendency for movements in London house prices to exceed those of the UK as a whole, amplifying UK trends in growth and decline. In addition, commentators have noted that London trends in house prices tend to anticipate those across the rest of the UK. There has been much recent discussion of a specific ripple effect on house prices through the country with London as the epicentre.

Figure 1.2: House prices – London and UK
(% year on year change in quarterly average house prices)



Source: Nationwide

The established surveys suggest house price growth has moderated…
The latest data from the Nationwide and Halifax indicates that whilst London house price growth has moderated over the past few months, it continues to remain relatively buoyant with no signs of an imminent collapse.

Looking at data for the first quarter of 2003, the Nationwide survey suggests that the cost of property in London increased by 3.4 per cent during the first quarter of 2003, compared with 3.9 per cent across the UK as a whole. In comparison, the Halifax survey pointed to a 2.7 per cent increase in London during the first quarter of 2003.

Table 1.1: Recent London house price change (%)

	Q4 2000 – Q4 2001	Q4 2001 – Q4 2002	Q1 2003
Nationwide	14.3	21.4	3.4
Halifax	17.0	19.4	2.7
Land Registry	3.9	18.8	-
Rightmove	-	16.2	3.8
Hometrack	-	-	-0.3

…largely due to falling prices at the top end of the market
This moderation in house prices has been largely driven by falls at the top end of the market. The substantial stock-market falls of the past couple of years have finally had some impact on the City resulting in job cuts, low bonus payments and general employment uncertainty. This in turn has impact on demand for London's more expensive property.

The Hometrack and RICS surveys suggest average prices may be falling
There is some disagreement amongst the available Survey data however (see Appendix). According to the Hometrack survey of London estate agents the price of the average London house has actually fallen marginally over recent months.

The latest RICS survey is rather more pessimistic with its panel of chartered surveyors suggesting that London house prices are falling at the fastest pace in nearly a decade, contributing to a fall in house prices across the whole of England and Wales.

RICS blamed current economic uncertainty and further doubts that were generated by the war in Iraq encouraging homebuyers to take a wait-and-see approach. However, they do emphasise that the fundamental drivers of house prices remain strong with interest rates and unemployment remaining low, pointing to a short-lived downturn.

1.3 London sub-market prices

Detached house prices grew more slowly than the London average in 2002…
Information about changes in average London house prices hides significant variations in house price trends within London's sub-markets. Using Land Registry house price data the table below indicates the range in average prices by type of property and variations in house price growth by type during 2002.

Table 1.2: Average price of London residential property sales completed by property type

	Av. Price Q4 2002	Change Q4 2001 – Q4 2002 (%)
Detached	493,978	17.6
Semi-Detached	270,525	20.7
Terraced	244,106	18.3
Flat/Maisonette	208,671	18.2
All	241,838	18.8

Source: Land Registry

It provides an initial indication of the pattern of slower growth amongst more expensive housing that was beginning to emerge by the end of 2002. The price of the average London detached house grew slightly more slowly than the average house during 2002.

…whilst prices in the central London boroughs grew more slowly than outer
The considerable geographical variations within Greater London highlight this trend much more clearly. House prices in the expensive inner London boroughs of the City, Westminster and Kensington and Chelsea grew most slowly during 2002. It was in outer London boroughs to the North, South, East and West that house prices grew most rapidly.

Table 1.3: Average house price growth by London borough (Q4 2001 to Q4 2002)

Top 5		Bottom 5	
Barking and Dagenham	30.9	Tower Hamlets	11.7
Waltham Forest	27.3	Southwark	10.7
Bexley	26.0	City of London	9.0
Brent	26.0	City of Westminster	5.5
Harrow	25.6	Kensington and Chelsea	2.6

Source: Land Registry

2. The demand for and supply of housing

2.1 The housing market

Is there such an entity as a housing market?

In terms of a standard economic model, recent rapid house price increases can be seen as the product of an imbalance between the supply and demand for housing: market failure in the housing market. Yet can we usefully theorise about such a market?

In a smoothly functioning market, an imbalance of supply and demand would eventually self-correct – excess demand should result in an increase in supply. Yet there are some innate qualities to housing that makes it a rather complex market place – indeed so complex that the concept of the market clearing, a situation where supply and demand find a balanced equilibrium position, can seem absurd.

Housing has some very particular characteristics…

What follows is a list of some of the very particular features of housing that complicates any economic analysis of the housing market.

- Having a roof over one's head is a necessary good.
- A house is also a home: an emotional as well as a financial investment.
- Housing absorbs a large proportion of individual/family income or wealth.
- Houses tend to be long-term investments – they are very infrequent purchases.
- A house is a locationally specific or positional good (only houseboats, caravans, tents and mobile homes can be moved).
- Personal relationships and trends in family/social behaviour influence individual sale and purchase decisions.
- Housing supply tends to adjust very slowly to increased demand, whilst demand has a tendency to overshoot.
- Housing is heterogeneous – the term 'housing' covers a wide variety of types of property and tenure and demand for each responds to varying trends, for example, in taste, demographics.
- Housing is both consumed, and bought as an asset: owner-occupiers consume property (like tenants), but are also buying assets.
- Both house builders and house owners are dependent on finance markets (which may be far from perfect).
- House prices are negotiated.
- The housing market is largely a second hand market – new build represents a very small proportion of the supply of housing.

…which produce a complex set of market dynamics

These characteristics raise a wealth of issues, some of which are tackled in this report. Certainly housing economists all emphasise the complexity of the housing market and this complexity means that it does not lend itself to straightforward modelling.

The housing market can be viewed as a series of interlinking sub-markets…
Economists tend to view housing as a series of interlinking sub-markets. These sub-markets are defined mostly in terms of tenure (eg owner-occupied, private rented), house type (eg large family house, two-bed flat) and geographical location (eg regional, city, neighbourhood).

The analysis of recent trends in the London market in the previous chapter highlighted some of the differences within these sub-markets. Larger properties in the wealthier central London neighbourhoods have seen some serious falls in value over recent months, whilst smaller properties in less desirable areas have not. The differences between price trends in the owner-occupied and private rented sectors are particular profound, yet still interlinked in a rather complex way.

…but it is valuable first to take an overview of the drivers of supply and demand.
Yet whilst recognising the complexity inherent in a market made up a series of sub-markets it is important to take an overview. This chapter looks at the London housing market in terms of factors driving supply and demand, where the market fails, and how government intervenes to improve efficiency, equity or to pursue other goals. Given that the majority of housing in London is owner occupied, this report focuses primarily on the market for the buying and selling of property, rather than the rental market, though clearly many of the dynamics are the same.

2.2 Demand fundamentals

The decisions of house-buyers are influenced by house prices, their income and mortgage rates…
For the first-time buyer, the financial decision as to whether or not to enter the housing market is influenced primarily by house prices, their income, and mortgage interest rates. At the most simple level therefore, the demand for housing will be influenced by these factors. However, the fundamental drivers of change in the demand for housing are rather more varied.

…but more fundamentally housing demand is driven by demographic and social change…
The first group of factors driving changes in the demand for housing are demographic (encompassing factors such as population growth and changing age profile) and social (such as the divorce rate and the average age of household formation). These directly influence the pattern of change in the number of households.

…as well as economic change and government policy
The second group of factors are economic. The state of the London economy is reflected in average earnings growth, employment, unemployment and consumer confidence, which impact on individuals' financial decisions. In addition the state of the UK and world economy influences interest rates, which have a direct influence on housing demand. The economic confidence of financial institutions affects their lending policies and thus the availability of finance to potential house buyers.

The final group of factors relate specifically to government policy – the way in which government intervenes in the market through changes in taxes (eg stamp duty) or subsidies (eg right to buy), and through market regulation (eg the planning system) may have some impact on demand. These non-market factors are not the subject of this chapter but are discussed later in this report.

Household numbers are increasing in London

Following a period of decline in the number of households[2] in London in the 1970s, the number has since been on the increase. This is forecast to continue and according to Greater London Authority estimates at a faster rate than at any point since the Second World War[3].

The main contribution to recent household growth has come from net in-migration and natural growth, but with an additional and growing contribution from social factors such as the tendencies towards a higher divorce rate and people living alone, resulting in a decrease in average household size.

London's population has been growing since the mid 1980s…

The population of London stabilised in the mid 1980s after a long period of decline. It has since been growing at a steadily increasing rate and is expected to continue growing. The latest GLA central projection based on 2001 census results is for a London population of 7.9 million in 2016[4].

Table 2.1: Greater London households and population 1971-2016, thousands

	Household Numbers	Population
1971	2,705	
1981	2,635	6,806
1991	2,841	6,826
2001	3,056	7,188
2016	3,473	7,899

Source: GLA (2003)

…the product of net international in-migration…

Greater London had been experiencing net out-migration during the first half of the 1990s. This trend has turned around and is now a key contributor to household growth – a trend that is expected to continue and grow. Most of this is attributable to net international in-migration. These migrants tend to be at either end of the income scale, encouraging growing trends in income disparity in the capital and with implications for housing[5].

[2] A household is defined as any single person or group of people living in a single dwelling
[3] London Mayor's Housing Commission (2000)
[4] GLA (2003)
[5] London Mayor's Housing Commission (2000)

Table 2.2: Greater London migration 1991-2001, thousands

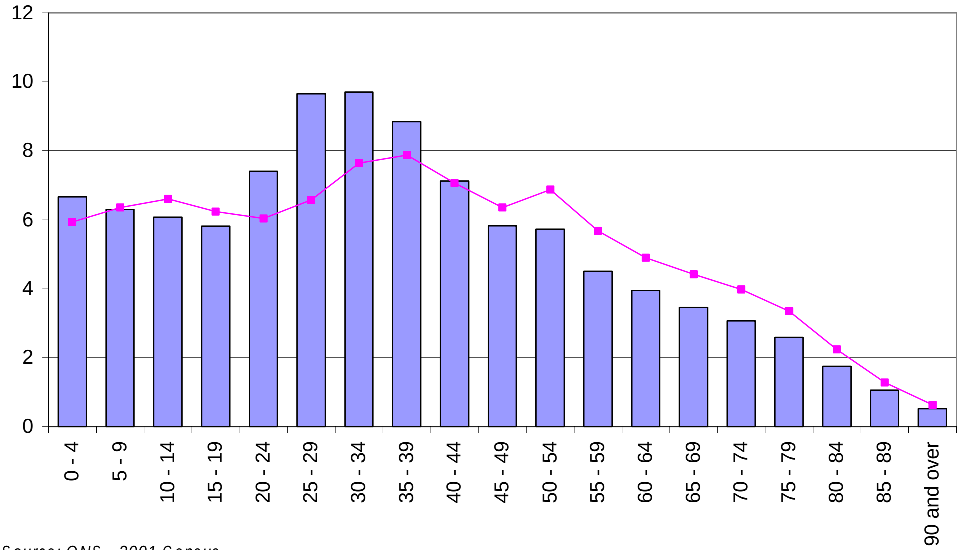
	International Migration			UK Migration			Total
	In	Out	Net	In	Out	Net	Net
1991-92	95.2	91.3	3.9	53.9	208.2	-54.3	-50.4
1992-93	90.1	70.8	19.2	149.9	200.4	-50.5	-31.2
1993-94	100.5	74.2	26.3	152.7	203.4	-50.7	-24.5
1994-95	102.0	80.1	21.9	166.6	207.8	-41.2	-19.2
1995-96	119.8	69.8	50.0	168.8	208.9	-40.1	9.9
1996-97	111.3	79.6	31.7	168.5	217.7	-49.2	-17.5
1997-98	139.0	97.1	41.9	169.5	221.5	-52.0	-10.0
1998-99	180.9	101.3	79.6	167.6	220.1	-52.5	27.1
1999-00	193.1	106.4	86.7	163.3	233.2	-69.9	16.8
2000-01	208.6	109.5	99.1	163.6	232.2	-68.6	30.5
Annual Ave 1996-01	166.6	98.8	67.8	166.5	224.9	-58.4	9.4

Source: GLA (2003)

With the rest of the UK, London continues to experience net out-migration, although this is largely due to substantial net out-migration to the East and South East regions.

…and natural growth due to the young age profile of residents and in-migrants
There are strong age patterns amongst migrants that have implications for housing, as in-migrants are more likely to be young whilst out-migrants are biased towards older age groups. The age profile of London residents is unusually dominated by the 20-39 age group.

Figure 2.1: Age profile – London and UK (% by age group 2001)



Source: ONS - 2001 Census

These patterns mean that birth rates currently outstrip death rates by over 40,000 per year. This level of natural growth has been gradually on the increase since the mid 1990s, a trend that is expected to continue. By 2016 the GLA forecasts that natural population growth will exceed 60,000 per year.

The number of one-person households continues to rise

The number of households is forecast to rise by an average of 27,800 a year to 3.47 million by 2016. Nationally, two-thirds of the growth in household numbers in the next 20 years is projected to be in southern England, with 20 per cent concentrated in London.

Looking at a breakdown of this change in households by type shows some significant social trends taking place. Married couple households are on the decrease, whilst co-habiting couple households are on the increase by a very similar amount. More important, in terms of its implication for housing demand, is the significant increase in the number of one-person households.

Table 2.3: Greater London household projections, by type of household, thousands

	1991	1996	2001	2006	2011	2016	Change 2001-16
Married couple households	1,244	1,130	1,049	965	909	872	-177
Co-habiting couple households	196	243	337	421	484	525	188
Lone parent households	191	230	263	286	304	319	57
One person households	882	955	1,044	1,121	1,202	1,300	255
Other 2+ person households	298	327	363	395	426	457	94
Total households	2,809	2,884	3,056	3,188	3,325	3,473	417

Source: GLA (2003) Population and Household Forecasts based on the First Results from the 2001 Census, SDS Technical Report 23

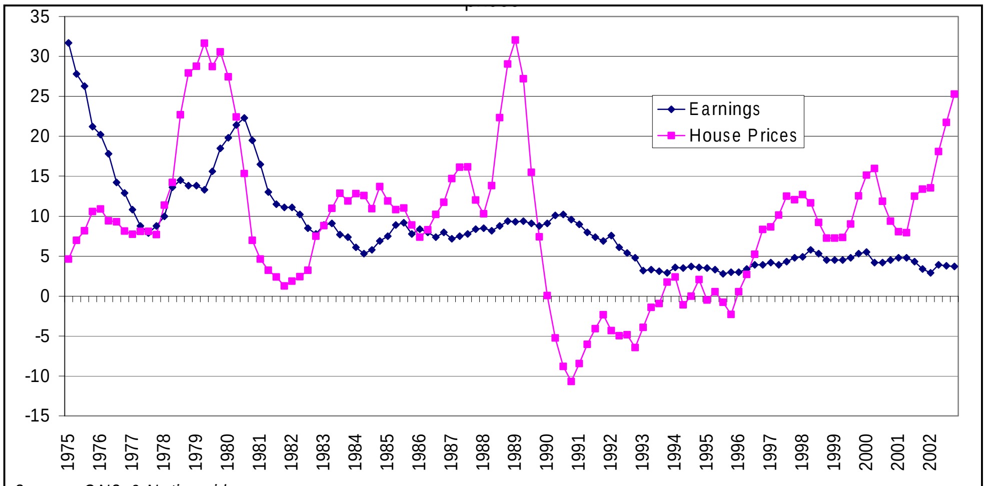
London's economic success is largely responsible for its housing problems

The economic strength of London as one of the world's major cities, whilst adding significantly to the income and wealth of its residents, has been the prime cause of its housing problems. As a major and growing financial and services centre it continues to attract people from the rest of the UK and overseas to its opportunities for employment, education and recreation.

Earnings have been increasing steadily…

Economic growth implies increased earnings and incomes of the capital's population. Certainly average earnings growth rates over the past couple of decades have grown consistently, as can be seen in Figure 2.2.

Figure 2.2: Earnings and house price growth – UK
(% year on year change, quarterly average earnings index and average house prices)

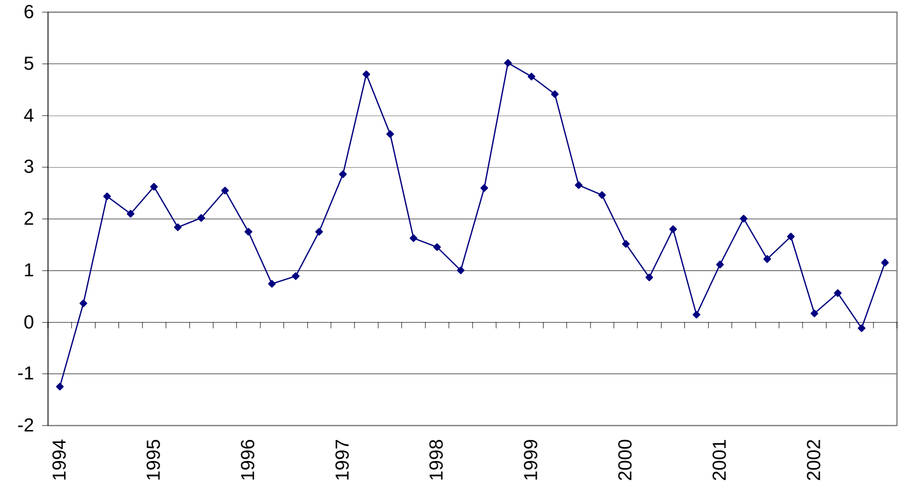


Source: ONS & Nationwide

…with employment steady…

London house price growth since the mid-1990s has coincided with a period in which employment has grown significantly. Whilst over the past year growth has been relatively marginal, there has been an environment of general employment stability has been sustained.

Figure 2.3: Employment change – London
(% year on year change, quarterly employment 1994-2002)

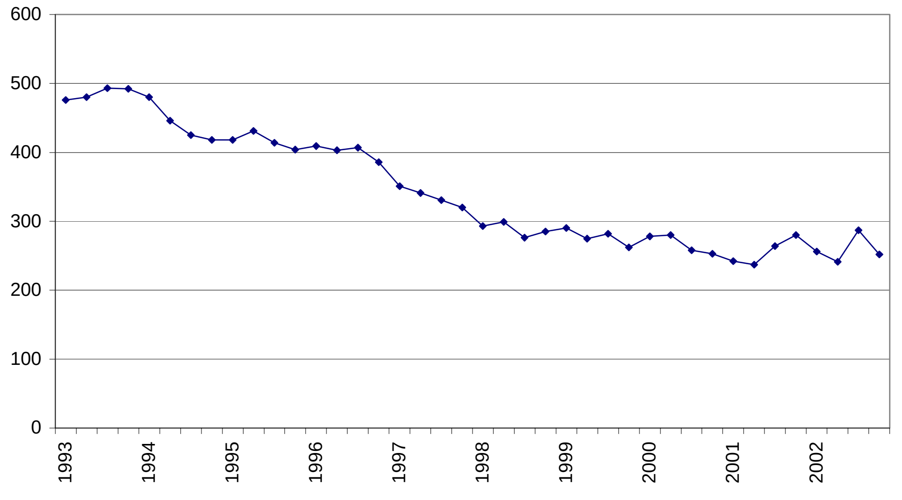


Source: ONS - Labour Force Survey

…and unemployment on the decline

Unemployment levels have a profound influence on the confidence of investors and thus have some influence on the housing market. Unemployment levels have been in steady decline since the early 1990s. There has been some fluctuation in unemployment over the past two years, but no significant increase.

Figure 2.4: Unemployment – London (thousands employed, quarterly, 1993-2002)

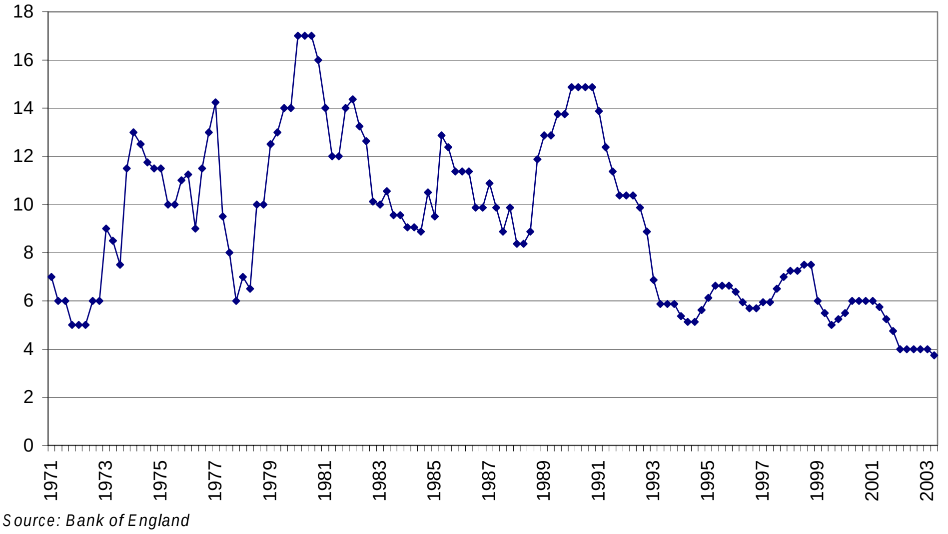


Source: ONS: Labour Force Survey

Interest rates are at their lowest for decades…

Whilst the employment environment in London has been very stable in recent times and earnings have been growing steadily, the cost of mortgage finance has never been so low. Base rates have been on the decline since the early 1990s, and have now reached their lowest level (3.75 per cent) since 1955. Mortgages rates have therefore been very low, drawing mortgage repayments downwards.

Figure 2.5: Bank of England interest rates (money market intervention rates – beginning of each quarter)



Source: Bank of England
Bank Rate (1970-72), Minimum Lending Rate (1972-81), Minimum Band 1 Dealing Rate (1981-97), Repo Rate (1997-

…with mortgage finance easy to access
In addition, there are currently relatively few problems regarding access to mortgage finance. With financial deregulation and the entry of banks into the mortgage market in the 1980s and 1990s, competition amongst mortgage lenders has intensified. Indeed some have voiced concern that mortgage finance has become too easy to access and that the recent strength of house prices partly reflects these better credit conditions. Certainly loan to house price value ratios are very high in the UK[6].

Residential property has represented a good investment compared to alternatives
With house prices rising fast, residential property has represented a good investment over recent years. With the collapse in equity prices since 2000, bricks and mortar has represented far better value. Indeed some recent research from Nationwide suggests that over the last five years equities have under performed housing by nearly 25 per cent per annum. The rise of the buy-to-let market has been one of the consequences of this, with an increasing number of people in the capital becoming landlords in recent years. In addition there is strong anecdotal evidence of significant investment in the London housing market from abroad.

In summary - London housing demand has been growing
The current situation with regard to housing demand in London is one of growth. Growth in the population, driven largely by international in-migration and natural change due to the young age profile of residents and in-migrants, is driving household growth and generating increased demand for housing. In addition there is a benign economic environment for house purchase with low interest rates, steady earnings growth and employment stability. On top of this, returns over recent years on investment in residential property have exceeded those on equities.

2.3 Supply fundamentals

The forces affecting supply are as complex as those influencing demand
The forces affecting the supply of housing are equally as complex as those influencing demand, though economists have carried out far less research on the subject. Housing supply in the UK is currently the subject of a major piece of government research led by Kate Barker and announced by the Chancellor in his 2003 budget statement.

Increased demand is largely met by the activities of private house builders
Housing supply can be met by building new houses, getting empty houses back into use and converting non-residential buildings into residential use. Whilst a small part of any increase in the demand for housing may be addressed by seeking to reduce the proportion of homes that are empty an any one time, the majority will be due to the activities of private house builders.

House builders decisions are influenced by house prices, land prices and construction costs…
In theoretical terms, decisions of house builders are driven largely by:
- house prices
- land prices
- construction costs.

[6] IMF (2003a)

…but other factors such as land availability and the availability and cost of finance are important too

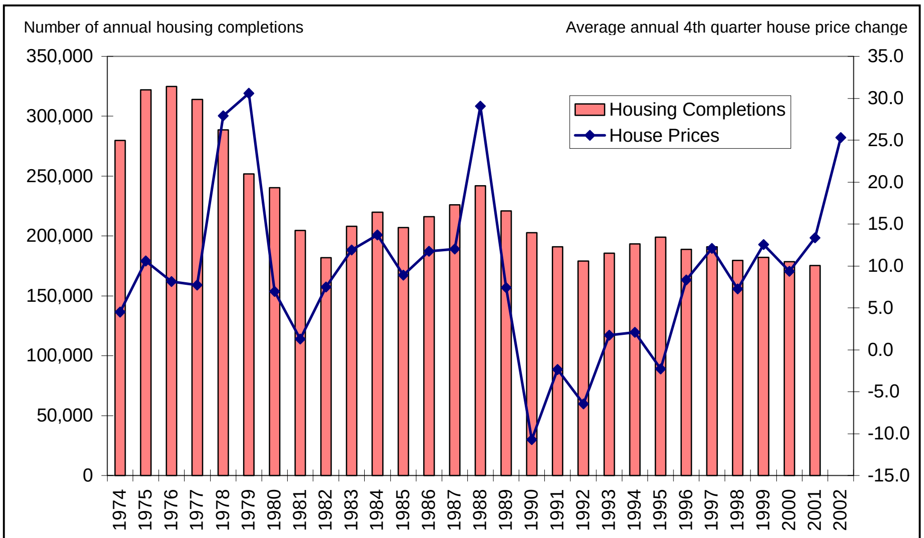
However, other underlying factors are also likely to be important. These include:

- land availability
- interest rates – cost of finance
- availability of finance.

UK housing supply is relatively unresponsive to house price changes…

Figure 2.6 gives some indication of the responsiveness of the house building market to changes in house prices across the UK. Modest increases in the supply of completed houses took place at the time of the last two house price booms, but annual completions have not tended to vary radically. For example, during the last boom completions peaked at 242,000 in 1988, representing a 33 per cent increase on the worst year for housing completions – 182,000 in 1982.

Figure 2.6: Housing completions and prices – UK



Source: ODPM Housing Statistics & Nationwide

…the supply of new housing is renowned for being price inelastic

With increasing prices one might reasonably expect an increase in the number of new homes being built, as house builders recognise the potential to make greater returns and thus expand output, whilst additional new firms enter the house building market. In reality, however, the supply of new building is renowned for being inelastic, in other words supply tends to be rather unresponsive to increased demand, over the short term.

The pattern of land price growth is highly correlated with house price growth…

Changes in residential land values unsurprisingly tend to be highly correlated with house price inflation. However, according to recent research by Halifax (2003a) residential land values over recent years have seen far more volatile peaks and troughs.

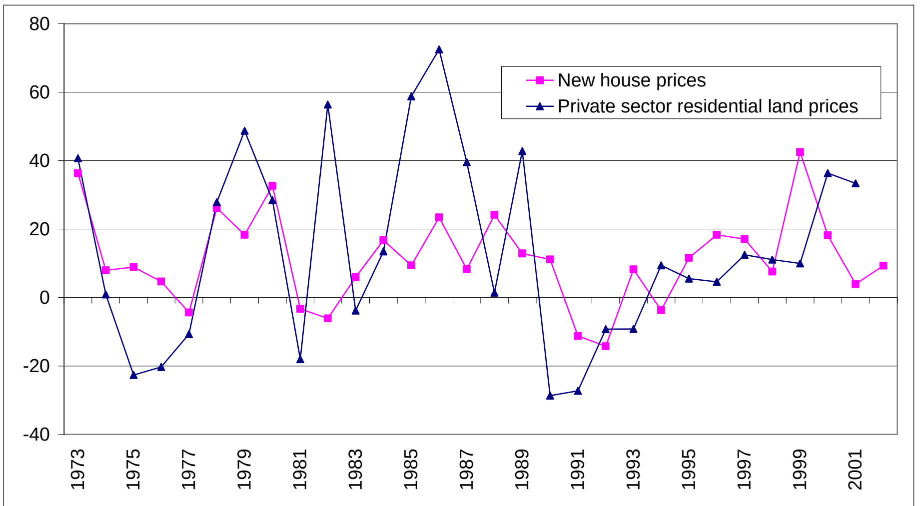
In the period 1988 to 1992 house price inflation, as measured by Halifax, fell from 34.1 per cent to minus 8.4 per cent. The value of land (according to data sourced from the Valuation Office) mirrored this trend more sharply, falling from 98.5 per cent in 1988, to minus 25.8 per cent in 1990.

…with residential land prices rising faster than house prices over the past 20 years, but at a broadly similar rate over the past ten years

This means that over the last 20 years the cost of residential building land has risen faster on average than house price values. The cost of land rose by 808 per cent across the UK (excluding London) between 1983 and 2002, significantly outpacing the 306 per cent increase in house prices over the period. In London, residential building land prices have increased by 624 per cent, a lower rate of growth than the rest of the UK, but from a much higher base than any other UK region. Over the same period London house prices have increased by 456 per cent and new houses by only 355 per cent.

This trend is shown clearly in Figure 2.7, however, it can also be seen that over the past ten years land and house price growth rates have been broadly similar.

Figure 2.7: New house and land prices – London (% change, annual average prices)



Source: ODPM

London land price growth has recently fallen behind house price growth…

Recently published research by FPD Savills[7] suggests that urban land values across the UK have grown more slowly than average house prices over the past two years. They do not, however, make the comparison with new build house prices.

…with affordable housing agreements possibly having some influence…

One of the reasons they suggest has contributed to this slow down is the imposition, or proposed imposition, of more onerous conditions on urban land in the form of section 106 and other affordable housing agreements. These conditions, they report, create enough cost uncertainty to depress prices.

[7] FPD Savills – UK Land and Development Research Bulletin – No.1 March 2003

…but by far the most important factors are over valuation…

Clearly many developers are expressing concern about such agreements, but there is no evidence to show that they have any direct effect on land prices. When looking for reasons for the recent slow down in residential land prices, by far the most important factor will have been the very rapid growth in urban land prices that began in 1994. Eight years of residential land price growth exceeding new house price growth in London will have resulted in very fully, or even over, valued land.

…and less attractive residential sites.

There is strong anecdotal evidence from developers to suggest that following a 'feeding frenzy' by house builders to obtain urban sites which resulted in land price growth in London of as much as 36 per cent in 2000, currently available sites tend not to be 'easy' with issues such as difficult land ownership, contamination or accessibility problems. As a consequence residential land prices have not been growing as fast as house prices.

Yet the volume of residential land being sold has fallen since 1997

Yet the amount (measured by hectares rather than the number of transactions) of residential building land actually being sold across the UK has fallen significantly in recent years. Since a noticeable boom in 1997 when 6,207 hectares of residential building land were sold, the volume has fallen to 2,579 in 2001.

The conditions regarding cost and availability of finance are currently favourable

As discussed earlier with regard to housing finance for purchasers, with interest rates currently at such low levels and a generally benign economic environment, neither the cost or availability of finance represent a particular issue at the present time or in the recent past.

There are no indications that residential construction costs are increasing particularly strongly

Available data from the Department of Trade and Industry (DTI) concerning the costs of the construction industry in Great Britain provide no indication that costs are rising particularly rapidly. Between 1997 and 2001 they rose on average by 3.5 per cent per year.

Though increasing wage costs may present some cause for concern

Gauging precise trends in London construction costs is unsurprisingly problematic. The main area of concern at present is skills shortages in the London construction industry. There is as yet no evidence to suggest that wage costs are increasing rapidly but the recent agreement regarding wages at the Heathrow Terminal 5 site have triggered some concern across the construction industry.

In summary – whilst demand has increased, supply has remained relatively static

Shortages of data make investigating the fundamentals of housing supply problematical. With house prices increasing rapidly over recent years, land prices have increased too. Overall there is no indication that costs for the construction industry have risen particularly rapidly, so with sustained increases in housing demand it is difficult to explain the relatively static level of supply. Land availability represents one key issue, which along with the structure of the residential construction industry is discussed in more detail in Chapter 4.

2.4 Market failure and government intervention

All governments intervene in the housing market…
Governments both central and municipal throughout the world intervene in housing markets. The motivations of governments to intervene are to remove specific market failure or to replace a market that isn't working. In addition, governments have used housing as a vehicle for other ends such as income redistribution, or regional growth.

…as market failure is endemic
Inefficiency and market failure are seen as endemic in the housing market. The complexity of the interactions within the market means that there is a high degree of noise and uncertainty about the nature and meaning of market signals.

Economists point to whole variety of areas of market failure: capital market imperfections, imperfect information and discrimination, the existence of externalities, and adjustment problems due to short run supply inelasticity.

Governments intervene through regulation, taxation, subsidy and direct provision or allocation
There are four main ways in which government intervenes.

- Regulation of the market – providing a legal framework including standards (eg planning regulation).
- Encouraging market operation – provision of market information.
- Taxation or subsidy policies – to deter and encourage activities.
- Government provision and or allocation (eg provision of council housing, allocating resources to housing associations.

Key areas of market failure
Some key areas of market failure in the housing market are:

- house price overshooting – imperfect information and discrimination amongst consumers induces slow adjustment of demand
- slow delivery of new housing – short run supply inelasticity
- under supply of affordable housing
- capital market imperfections
- low quality housing.

These represent some of the main issues dealt with in the following chapters.

3. Cycles, expectations and bubbles

3.1 Introduction

> It is hard to envisage how boom-bust housing instabilities help the economy's growth path or how rising real prices of housing facilitate British competitiveness in global markets. Maclennan (1994)

The UK housing market is cyclical
The UK housing market exhibits clear cyclical patterns. House price inflation over time, for example, shows a repeated tendency to rise and fall. In recent years, the UK housing market has been experiencing its strongest cyclical upswing since the late 1980s.

Bubbles occur when asset prices exceed levels explicable by trends in the fundamental drivers of growth
Over time, and in a variety of asset markets, there have been many examples of periods of rapid price growth gaining momentum to reach a point where the fundamental drivers of growth can no longer explain the price level of the particular asset. People purchasing the asset come to expect these rapid growth rates and a momentum is built up. This situation is known as a bubble. The likely consequence of such a bubble is a price crash.

The extremes of house market boom and bust are undesirable…
Duncan Maclennan's comment above on the UK housing market was made at a time when the country was in the process of recovering from a period of falling house prices. The bursting of the 1988 house price bubble with falling prices, combined with high levels of mortgage interest rates, left many recent buyers in a position of negative equity, some in mortgage arrears and others having had their loans foreclosed and properties repossessed. Such a situation is clearly highly undesirable, neither efficient nor equitable – a key area of housing market failure.

…and there continues to be concern about a possible collapse in the market
At the present time, with house prices having risen rapidly over a sustained period and recently approaching the growth rates of the last boom in 1988, there is understandable concern from many commentators about the potential for a bust. Such a bust in the market, with falling house prices, is only likely following a period of temporary overshooting of house prices that cannot be explained by the fundamental trends in demand and supply.

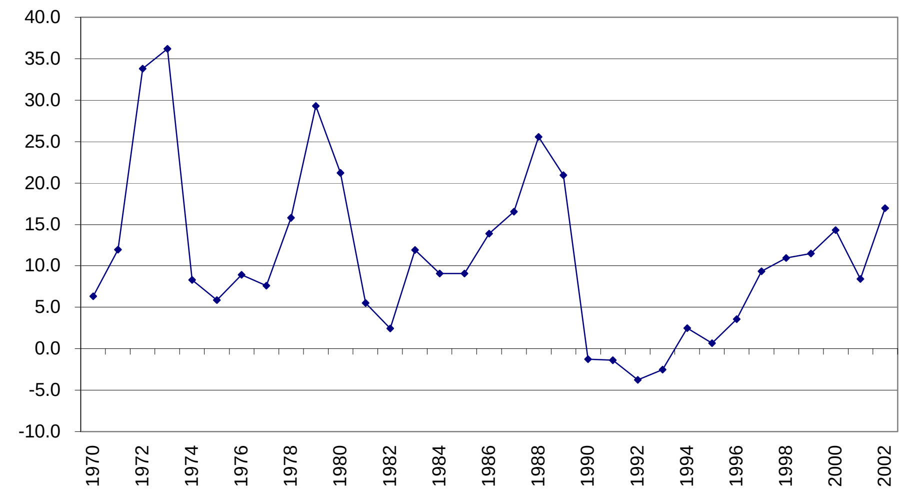
This chapter explores the extent of the cyclical nature of the housing market, the role that expectations play in these cycles, and assesses whether over the past year a house price bubble has emerged. In addition, it looks at whether policy intervention can generate greater stability in the housing market.

3.2 Cycles

House prices inflation has seen three major growth periods since 1970
Nominal house prices (unadjusted for general inflation) have increased over recent decades in a very cyclical fashion. Prior to the relatively rapid rise in house prices over the past few years there have been three distinct periods of high house price inflation since 1970. The first, in the

early 1970s, coincided with the oil crisis and a period of exceptionally high retail price inflation. The second occurred at the end of the 1970s and the third in the mid to late 1980s.

Figure 3.1: House prices – UK
(% year on year change, annual average house prices, mix adjusted index)



Source: ODPM Housing Statistics

The peak of 1988 was followed by house prices falling in monetary terms
The mid to late 1980s housing boom culminated in annual house price inflation reaching a peak of over 30 per cent – UK house prices doubled in just four-and-a-half years. The subsequent fall in prices began in mid 1989, and continued on a downward trend for the next six years before reaching a trough in July 1995. Across the country prices fell by 12 per cent over this period. In London, from the peak in 1989 to the trough in 1993, house prices fell by nearly 50 per cent in real terms.

The mid 1990s to 2002 has seen another period of escalating growth
From the mid 1990s UK house prices began to recover and began another period of growth. In London it took until 1998 for prices to return to their late 1980s peak, but the escalation in house price growth through to 2002 has been much charted.

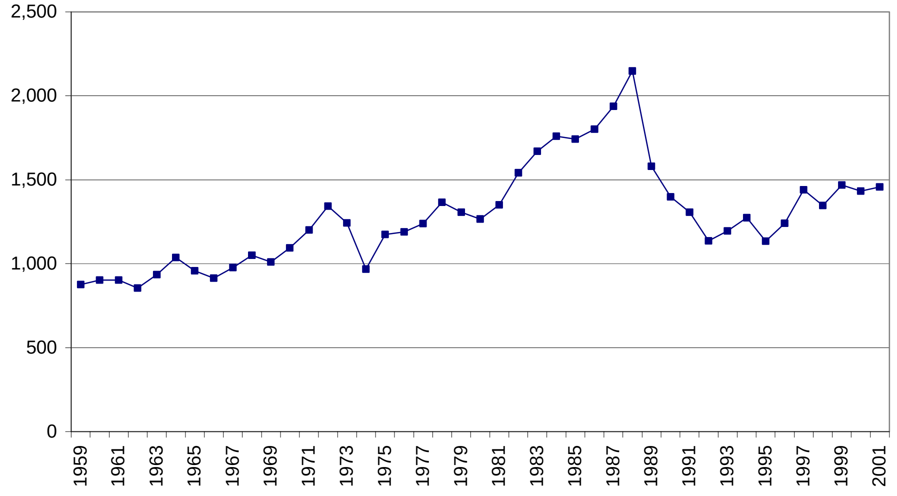
Housing market cycles are common to most countries…
Cycles in housing markets are not unusual in international terms. OECD research has shown that residential investment has a marked cyclical pattern in most economies[8].

…but the latest boom has exceeded that in the world's other large economies
The UK's latest house price boom, however, has outstripped that in any other of the world's large economies according to the International Monetary Fund's (IMF's) latest report on the UK economy.

[8] Maclennan and Meen (1993)

Cycles don't just affect prices, but also the number of transactions…
All aspects of the housing market have a tendency to be cyclical. Figure 3.2 shows that the number of housing transactions rose towards a peak in 1988, falling sharply, followed by more modest growth during the second half of the 1990s.

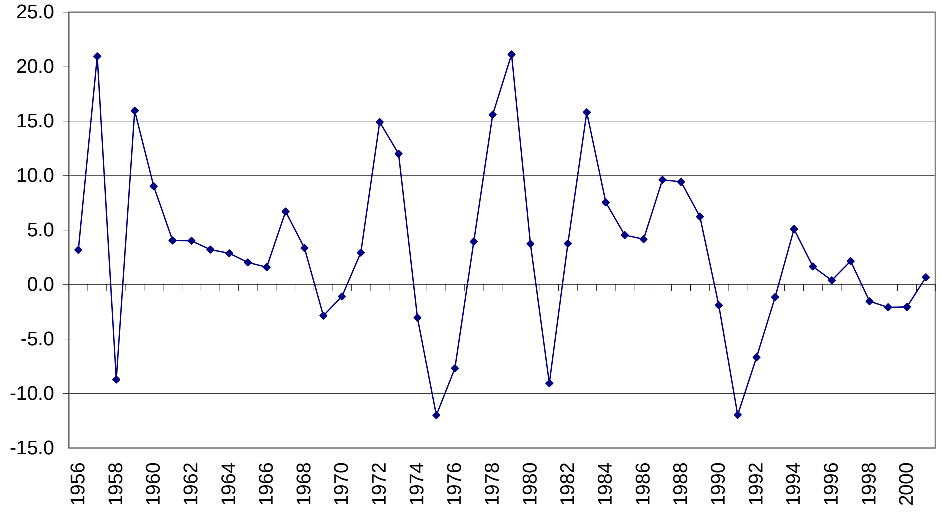
Figure 3.2: Housing market transactions – England and Wales (thousands, 1959-2001)



Source: Inland Revenue/Land Registry

…and construction sector activity
Real residential investment in the UK is a relatively volatile component of GDP. Construction sector output is widely recognised as being particularly responsive to changes in the health of an economy. Figure 3.3 shows the cyclical nature of the residential construction sector.

Figure 3.3: Residential construction industry output – UK (% year on year change, annual new build, repair and maintenance output)



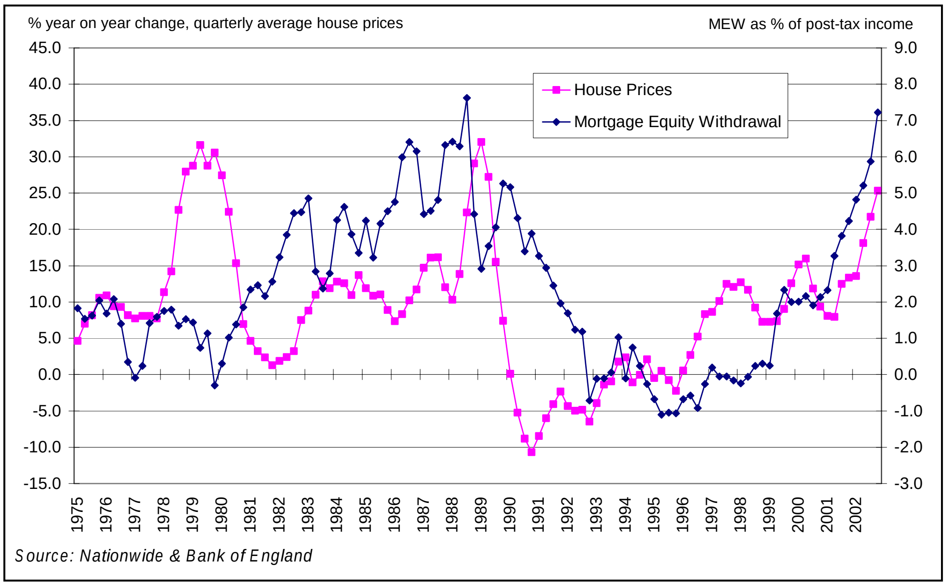
Source: DTI Construction Statistics

They also impact on cycles in the wider economy…
House price cycles also have a significant impact on cycles in the wider economy. Rising house prices have a tendency to stimulate increased consumption. Firstly, house purchases, particularly

by first-time buyers, generate significant demands for consumer goods such as furniture and white goods. Secondly, those who do not move find that the value of their house increases and thus their wealth increases.

…stimulating consumption
As a consequence of this feeling of increased wealth, house owners will tend to increase their consumption or alternatively re-mortgage in order to free up capital for consumption expenditure. Figure 3.4 indicates some degree of correlation between house prices and the extent to which house owners withdraw equity from their mortgages.

Figure 3.4: Mortgage equity withdrawal and house prices – UK



3.2 Bubbles

Bubble or no bubble?
Has the UK housing market been experiencing a price bubble? A bubble in a market suggests a period of rapid growth succeeded by a subsequent crash. The question is whether the recent rapid growth in house prices has been a reflection of market fundamentals (excess demand/low growth in the supply of housing) or whether there been a bubble implying a future crash. Are current price levels sustainable, or will there be a gentle landing?

The UK housing market seems to have a tendency to overshoot
Each major cyclical peak of price rises since 1970 has been followed by an unwinding period of two to three years when real house prices have fallen before they start to rise again. This suggests a well-established pattern of real house prices overshooting income growth.

Asset price bubbles gain a momentum that can cause prices to go on rising
In general, asset price bubbles are unpredictable. Prices can deviate from the underlying, fundamental value for prolonged periods and with analysts anticipating a bursting of the bubble, that bubble can get more extreme.

A growing bubble creates high returns to those who stay in. When that bubble becomes more extreme it becomes risky to bet against it. In theory a few rational agents betting against the bubble should stop the process, however, the greater the returns the larger the number of people required to bet against it.

Housing assets are particularly susceptible to momentum behaviour
House buyers are often relatively uninformed about fundamentals, but are responsive to price changes. As a consequence, housing is particularly susceptible to momentum behaviour.

House price rises stimulate increased demand for property…
When house prices rise there is a strong reason for the number of houses bought and sold to increase. Sustained house price increases may discourage some people from entering the housing market but actually tempts many others towards property. Non-house owners become aware of the capital gains to be made if they enter the housing market. They may well bring forward their purchase decisions to jump on the bandwagon whilst they can still afford to do so. Existing house owners similarly may seek to step up the size or quality of the property they own before they are unable to do so as property becomes more expensive.

…and price overshooting starts
In addition, some sellers holding units off the market until they can buy can give the impression of a shortage of property, thus increasing upward pressure on prices. As a consequence of these processes, price overshooting starts.

Individuals tend to underestimate the risks of a crash and expect prices to keep on rising
During bubbles individuals should recognise the risks entailed – that is, a subsequent sharp fall in house prices. However there are behavioural finance studies that show how individuals tend to underestimate risks when returns are particularly high. An environment takes hold in which everyone expects house prices to keep on rising

As a consequence prices go up further and a price inflationary cycle gains momentum. Households increasing their debt sustain the process artificially.

The bubble will only stop when first-time buyers stop entering the market
The only way to stop a house price bubble is for large numbers of people to get out and keep out of the private housing market. The housing market is not a flexible asset market – a house will generally represent an individual or family's biggest single investment. Timing exit and re-entry is very hard, so individuals will tend to stay in. In the housing market, efficiency is unusually reliant on those at the margin – in other words, the decisions of first-time buyers. The boom is only likely to stop when first-time buyers start to find that they really cannot afford to enter the market.

Housing market fluctuations are difficult to analyse…
The complexity of the housing market means that its fluctuations are very difficult to analyse. Identifying causality where multiple changes are taking place at the same time is notoriously difficult.

…but attempting to identify bubbles is important

If bubbles can be recognised better, then house buyers can be alerted and encouraged to amend their behaviour accordingly. One of the key aspects of a bubble is the inflated expectations of house buyers, based on imperfect information.

It is hard to coordinate against a bubble when there is no agreement that there is a bubble. Yet to achieve this a very detailed analysis of the UK/London housing market is needed, looking at the exact connections between changes in fundamentals and house prices. From this a model of the housing market can be constructed.

A recent IMF model suggests a bubble emerged in 2002

Evidence from a recent empirical model of UK house prices constructed by the IMF (2003a) suggests that house price increases rose significantly above the price increases predicted by their model in the first half of 2002. The model focused on two demand side factors – income and interest rates, and was thus rather limited.

The results from the study suggested that the current relative overvaluation is not as great as that at the peak of the last housing boom in the late 1980s. The report concluded that there is a 'likelihood that recent price increases are unsustainable and can lead to a sharp correction'.

Certainly house price to earnings and to income ratios are high…

The key indicators that proponents of a bubble theory refer to are deviation from long-term trends in the average house price to average annual earnings ratio (HPER) or house price to income ratio (HPIR). These ratios (discussed in Chapter 5 with regard to affordability) have certainly increased rapidly in London and have reached historically high levels, comparable to the levels they reached in the late 1980s prior to the crash in house prices which took place in the early 1990s.

…and indebtedness has been on the increase

Prior to the crash of the early 1990s there were also rising levels of indebtedness which exacerbated people's concern about their finances once the economy had started to turn down and contributed to the housing market crash. There is certainly clear evidence that household indebtedness has increased rapidly in relation to incomes in recent years, perhaps helping to sustain house price growth. As could be seen in Figure 3.4, mortgage equity withdrawal has reached levels comparable to the late 1980s peak.

Recent research published in the Bank of England Quarterly suggests that in particular the youngest and lowest-income households have increased their debt-to-income ratios the most – and from the highest levels – between 1995 and 2000[9].

Whilst households report that they are relatively comfortable with their higher levels of debt, this confidence could be eroded rapidly if economic circumstances deteriorated. Overall, the research concludes that changes in the distribution of household debt in recent years suggest that the household sector may be somewhat more vulnerable to an adverse shock than the

[9] Cox et al (2002)

aggregate measures indicate. This at least provides cause for concern regarding the possibility of a collapse in house prices.

However, recent high rates of price growth may reflect a fundamental change in the inflation environment…
If the high inflation rates of the 1970s, 1980s and the early 1990s, both in the UK and abroad, were the exception and not the norm in a long-term historical context, it can be argued that the establishment of an independent central bank in 1997 and targeted inflation rates has created an environment in which high inflation rates, and therefore high interest, rates are a thing of the past.

…with sustained lower interest rates producing a step change in house prices.
In this context, base rates should remain at low levels (comfortably below 7 per cent) and house price to earnings ratios will operate at a higher trend level. Recent rapid house price gains are therefore largely explained by lower interest rates in a more stable economic environment, resulting in a structural step change in house prices.

3.4 The future

It is unclear whether a housing market bubble has emerged…
The preceding discussion shows that evidence regarding whether there has been a bubble in the UK housing market is far from clear. It is not even clear in London whether the sustained period of very rapid house price inflation up to the end of 2002 is justified by the significant increase in unmet demand for housing.

…though current indications are that house price growth is moderating gradually
Gradually declining rates of London house price growth in the first quarter of 2003 lead most commentators to predict that the housing market is likely to see a soft landing rather than an imminent crash. The gentle slowdown is now the central view of most housing market experts with the probabilities of a boom and bust scenario having been lessened by the climate of uncertainty engendered by the war in Iraq and the economic uncertainty produced by stock market instability. The strong likelihood is now for a gentle landing and the probability that house prices in London will moderate to lower levels but not actually fall in real terms.

Housing market bubbles still provide cause for concern…
Some commentators look upon the housing market with its major cycles in house prices as the Achilles heel of the UK economy. Whilst there may not be another housing market crash the potential is still there. Imminent significant increases in interest rates are unlikely, but a downturn in the economy remains possible. This could result in increases in unemployment and a loss in confidence could still reveal the existence of a bubble in the market.

The UK's high loan to house value ratios may contribute to instability
The creeping up of loan to value (LTV) ratios has been highlighted as an area of concern. The recent report by the IMF suggested that high LTV ratios in the UK might be behind the speculative elements of house price dynamics.

We need to understand them better.
There is a strong argument that suggests that a housing market not prone to bouts of speculative excess would serve people better by. It is important therefore to understand them better – requiring more careful monitoring and more sophisticated modelling of the housing market. With a clearer understanding of whether or not house prices are over-inflated, better information can be made available to individuals to enable them to make more informed decisions about house purchases. The Chancellor's institution of two studies into housing supply and demand is to be welcomed.

4. House building and planning

4.1 Introduction

Growth in housing demand is largely met by house building…
Housing supply can be met by three main means:
- building new houses
- getting empty houses back into use
- converting non residential buildings into residential use

Clearly it is house building that will always represent the prime means of meeting growth in demand, and is the main focus of this chapter. The second and third means will be touched on in the final section of this chapter.

…but housing supply has been highly unresponsive to demand
Housing supply in the UK has tended to be highly unresponsive to demand. Economic studies of the UK housing market have generally shown that the price elasticity of housing supply is very low and has been declining over recent years, suggesting that house prices are largely determined by demand[10]. Inelastic housing supply means that increases in demand translate into higher prices rather than more housing. The inability of the private sector to supply sufficient houses has been the reason for governments intervening through programmes of house building.

The shortage of housing is an acute problem for London…
A shortage of housing is a problem in many areas of the UK, but it has become widely recognised that the problem is particularly acute in London. The Greater London Authority's draft London Plan (2002) outlines the need to house an additional 700,000 people in 345,000 new homes by 2016. This means that 23,000 new homes need to be built every year.

…and government is now committing resources to addressing the problem
Central government has now committed funding to encourage these targets being met. The publishing of the Office of the Deputy Prime Minister (ODPM) Communities Plan has provided some indication of where this money is going to be spent. For the first time in decades house building is being made a priority throughout London, but particularly in the Thames Gateway, an area broadly extending from Tower Bridge eastwards to Thurrock and Dartford, its boundaries crossing seven boroughs and a further eight councils.

Why haven't more houses been built in London and will more be built in the future?
This chapter takes a brief look at the history of UK house building, and specifically at recent house building trends in London. It considers why more houses have not been built in the past – why supply has not been more responsive to demand. In addition, it looks at the planning system, at private house builders and housing associations to consider what the barriers are to increased supply. Finally, it takes a look at what the future holds for the supply of housing in London.

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[10] Meen (1996)

4.2 A brief history of house building

The past century has been one of continued concern about housing shortages
Concern about housing shortages has a long history. The overall shortage of dwellings in relation to the number of households seeking accommodation has been viewed as *the* dominant housing problem in the UK for most of the past century[11].

House building became a government priority in the post-war years…
Successive governments in the immediate post-war years set building targets and judged their performance in terms of the number of dwellings constructed per annum. Following on from the immediate post-war need for housing stock replacement, the prime motivation was to achieve a minimum standard of provision.

In the late 1970s with the level of house building having fallen significantly, the government Green Paper Housing Policy: A Consultative Document (DoE, 1977) recommended that there was a need for 310,000 housing starts per year until the end of the century in order to keep pace with the baby boom of the 1960s.

…but was curtailed under the Thatcher government
However, the election of a new government in 1979 resulted in a significant change in emphasis of government policy. The council house-building programme was curtailed, and instead owner-occupation was promoted through offering council house residents the opportunity to buy their properties at a highly discounted rate – the right-to-buy (RTB) policy.

Research has consistently recommended increases in house building...
Research continued to be published throughout the 1980s and into the 1990s pointing to the need to build more housing. For example, the Joseph Rowntree Foundation published *Inquiry into British Housing* in 1991, which recommended the need to build 228,000 to 290,000 houses per annum across the UK up to 2001.

…and continues with the draft London Plan recommendations
The recommendations of the draft London Plan, which include 23,000 additional homes per year as a minimum target, based on research carried out by the Greater London Authority[12], therefore represent the latest in a long history of research recommending an increased rate of house building in the UK.

The level of house building has more than halved since 1968…
Available official data on house building, which has been collected since 1949, shows that house building in the UK peaked in 1968 when over 425,000 houses were built. Since then building levels have fallen away with 2001 seeing less new homes built than in any year since 1924.

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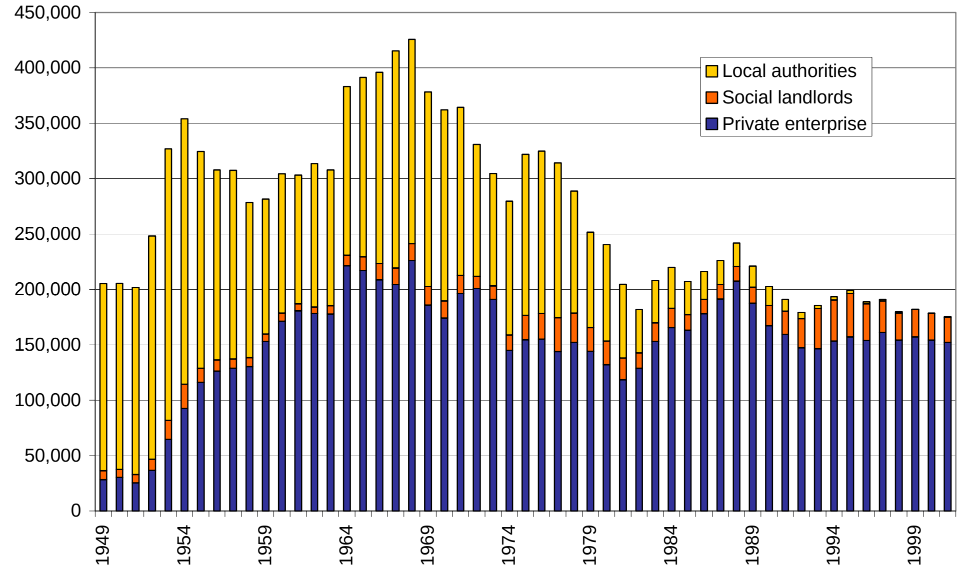
[11] Le Grand, Propper and Robinson (1992)
[12] GLA (2000), Housing Capacity Study

Figure 4.1: Source of housing investment in the UK (new housing completions 1949-2001)



Source: ODPM Housing Statistics

...remaining relatively stable since the early 1990s

In fact levels of supply over the past couple of decades have remained relatively stable, but the levels have been modest compared to the 1950s, 60s and 70s. Figure 4.1 shows this pattern clearly.

The main reason for the decline in house building is the almost complete cessation of local authority house building

The main difference between the situation now and that in 1968 is the amount of local authority (council) housing being constructed. In 1968, 43 per cent of the housing completions were local authority built, whereas by 2001 the proportion had fallen to 0.3 per cent.

A small proportion of this local authority building has been replaced by an increase in social landlord (housing associations) building, but this increase has been very marginal. Housing built by private companies has fallen from 226,000 to 152,000 since 1968, but essentially the difference with 1968 is the almost complete cessation of local authority house building.

4.3 House building in London

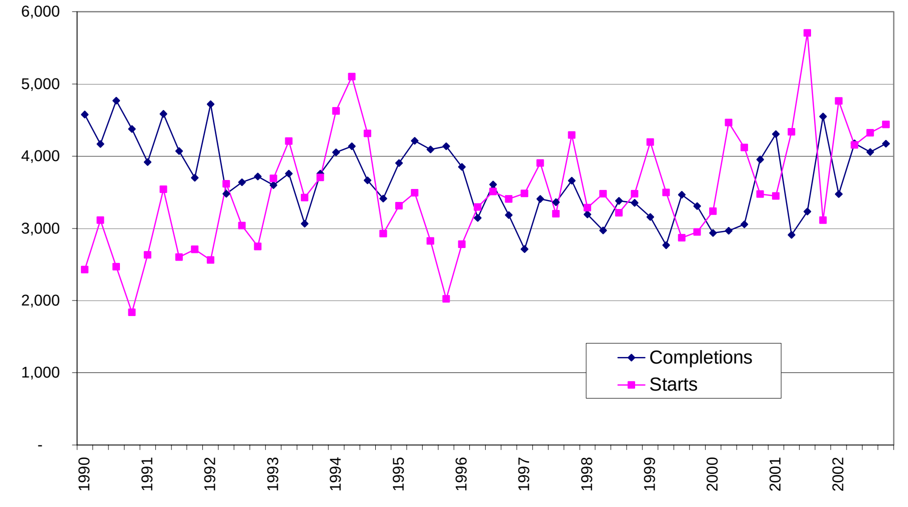
London is currently seeing very few new houses built…

The situation in London is more serious than in the UK as a whole, with a very small number of houses being built each year. According to official data, 16,260 houses were completed in the four quarters to Q3 2002, representing a modest increase on recent years.

…with an average of 14,000 houses built each year over the past decade

As can be seen from Figure 4.2, housing provision in London has been relatively stable over the past decade. On average, approximately 14,000 new houses have been completed per year in London over that period.

Figure 4.2: Housing provision – London (number of housing starts and completions, quarterly, 1999-2002)



Source: ODPM Housing

If other sources of housing are included (eg conversions, housing in previously empty properties) then estimates for the last decade are closer to a fairly constant supply of 20,000 units a year[13].

Housing starts are growing…

Indications from the latest housing starts data are that some growth is currently taking place in London, but the increases are very modest.

…but a fundamental step change is needed.

Modest increases will make little dent in the underlying shortage of housing both for sale and rent in the capital. The demand for housing in London exceeds supply and has been rising rapidly.

Estimates of future housing demand based on the Mayor's Housing Commission (2000) forecasts suggest that future demand for new homes to 2016 will average out at 31,900 per year[14]. Of these 25,700 homes will need to be 'affordable'. In the words of John Prescott: 'We need a step change in our approach to tackle these problems'[15].

Why have more houses not been built in London?

So the most important question is why so little house building has been taking place in London over recent years when house prices have been rising so rapidly.

[13] Housing Corporation and GOL (2002)
[14] Housing Corporation and GOL (2002)
[15] ODPM (2003)

The main issues relate to:
- structural issues in the UK house building industry
- the decline in social housing provision
- the planning system.

These are discussed in the following sections.

4.4 Private sector housing provision

Most houses are built speculatively…
Most houses are built on the basis of speculation. It takes a considerable amount of time (usually measured in years) from the purchase of land to completion. House builders therefore make decisions on the level of housing starts based on the anticipated state of the market some considerable time ahead.

…and thus there are inherent risks in the house building business
With future prices unpredictable, this makes the returns on investment unpredictable. Building houses is an inherently risky activity.

There are many small firms in the house building industry…
It is also the case that the private house building industry in the UK has a preponderance of small firms. Whilst there are a handful of large, well-known house building firms, DTI figures show that 96 per cent of all construction firms are classified as small businesses, employing 13 or less employees.

…making the industry particularly responsive to cost fluctuations
Being small they are more sensitive to fluctuations in costs and prices. As a consequence the health of the industry as a whole is strongly influenced by changes in interest rates.

This leads to a natural conservatism in terms of supply levels…
Concern about the risk involved in speculative house building leads to a tendency towards conservatism in the industry and thus reduces the responsiveness of supply to market price signals. It is in the interest of residential builders not to overstretch themselves and maintain as steady a supply (under-supply) of housing as possible. Developers are undoubtedly cautious about expanding supply when macro-economic conditions are uncertain.

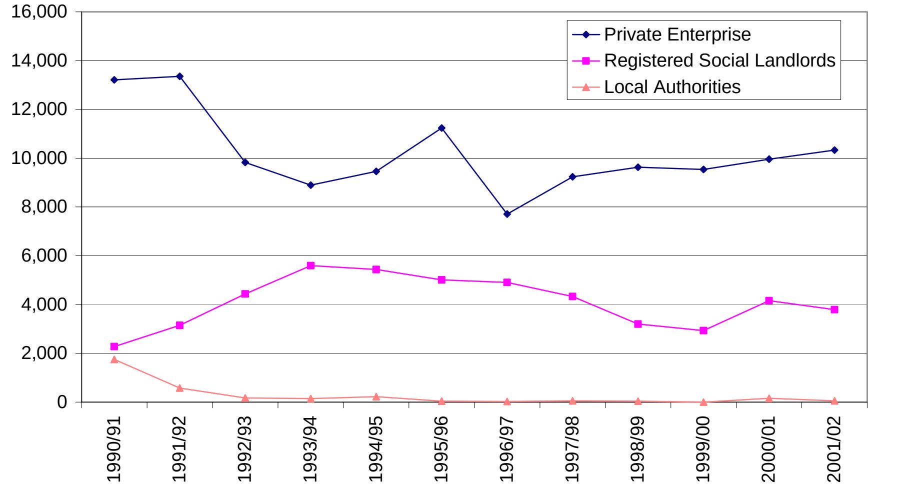
…technical conservatism, under-investment in training and further industry fragmentation
This also probably exacerbates the technical conservatism of house builders, as well as under-investment in training and further fragmentation of the industry through the spreading of risk amongst numbers of companies/sub-contractors.

4.5 Social housing provision

Local authorities are now building very few properties in London
As discussed earlier the main reason for the decline in house building since the end of the 1960s is the almost complete cessation of local authority house building. According to official ODPM data, local authorities in London completed less than 1,000 dwellings in the ten years up to 2001/02. Yet in 1990/91, 1,700 local authority dwellings were completed.

There has been some increase in properties built by RSLs over recent decades…
With the decline in the construction of local authority property, there has been some increase in registered social landlord (RSL) build over the past few decades but the increase has been very marginal.

Figure 4.3: Housing completions – London
(number of annual completions by type of developer, 1990/91-2001/02)



Source: ODPM Housing

…yet over the past five years the number of RSL built properties has declined
Looking at the pattern of completions in London over the past decade, the number of completions by RSLs has almost doubled. Yet over the past five years, whilst there has been some increase in the supply of private sector completions, RSLs have completed 23 per cent fewer new properties.

4.6 Planning regulations

There is fierce debate about the impact of planning regulations on the housing market
A recent analysis of house prices in the UK by the IMF asserts that the rigidity of the housing supply function in the UK is mostly due to restrictive planning policies[16]. The report cites Bramley's (1993) study of the UK housing market which finds that planning (proxied by the annual flow of new planning permissions) does not appear very responsive to market forces.

[16] IMF (2003a)

This view is one of the latest in the ongoing debate about where responsibility lies for the continuing low level of housing supply at a time when housing demand in the UK, and in London in particular, continues to be high.

There is broad international agreement on the importance of land use planning systems
There is broad international agreement that modern planning systems serve to regulate the use and development of land in order to protect and conserve the environment and to promote sustainable development and urban regeneration[17]. They enable government to intervene in the market to ensure some pattern and quality in development.

Even in the US there appears to be an increasing interest in growth controls and in looking at greater transport and infrastructural efficiency and environmental sustainability within the design of cities[18].

Planning regulations place restrictions upon the use of land...
The very nature of a land use planning system means that the UK planning system will place some restrictions upon the supply of residential land. The problem is that in London large increases in housing prices have not led to significant increases in land available for development.

…but does the planning system contribute to a shortage of development land?
A vital question is whether the planning system has actually contributed to a shortage in the supply of residential development land and whether this has resulted in some impact on increasing land and house prices.

Some have argued that the planning system has pushed up prices…
Evans (1987) has led the argument that the planning system can push up the price of land in the long run. He suggests that the planning system, through regulating the supply of usable land, reduces the extent to which house builders can respond to changes in demand. The evidence he provides is the extent to which land and house price inflation outstripped increases in household incomes and the retail price index throughout the 1970s and 1980s. At the same time house builders were spending large sums of money pursuing planning permissions and maintaining land banks, and that these sums were being passed onto consumers through higher house prices.

Cheshire and Sheppard's (1989) empirical study examined house prices in weak and strong planning control case study areas. They found that differences between the two planning regimes accounted for a price differential of up to 12 per cent between the two areas. They also found that the figure differed between house types.

…and produced higher density development
Evans (1991) contended that the restrictive planning regime in the UK has further distorted the market in the South East through causing a reduction in the size of houses demanded. With high increases in land prices, private sector development over the period 1969-89 moved

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[17] Jones and Watkins (1999), Bramley et al (1995)
[18] Danielsen et al (1999)

towards house types that consumed less land. Without being stated as an overt policy, the density of housing rose due to planning constraints, with the proportion of flats and maisonettes increasing and new bungalows becoming rare.

Others suggest that planning has no impact on prices

Grigson (1986) put forward an alternative view arguing that the planning system cannot push up prices in either the land or the housing markets. He observed that the supply of new-build housing is a relatively small proportion of the total supply of housing, which is dominated by the sale of second-hand units.

Bramley et al (1995) suggested that if housing allocations in development plans were significantly increased across the country, the effect on prices would be slight as prices are affected primarily by market changes rather than by planning controls.

The planning system is designed to respond to changes in demand…

The planning system is designed to respond to changes in demand. Prior to the Town and Country Planning Act of 1968, *blueprint planning* meant that a physical framework was provided within which the housing market operated – areas were designated for housing with density controls, building regulations, and planning and design standards.

After the 1968 act, however, the introduction of a system of *process planning* has meant that plans should be revised in response to changes in demand. This should ensure there is always an adequate supply of land for affordable housing.

…and some research suggests that it does succeed in this

There is research that suggests that the planning system does succeed in this to some extent. Monk et al (1996) noted that the planning system is not entirely unresponsive to increases in demand for housing. Their empirical evidence suggests that the planning system constrains the supply of land in general, but does respond to demand pressures subject to a time lag. This conclusion broadly matches that of Bramley et al (1995, 1998).

There is evidence to suggest that housing supply is not significantly constrained by the planning system in London

The debate summarised above indicates that there is strongly conflicting evidence as to whether the planning system is contributing to price increases and restricting supply. The recent research carried out for the GLA and the House Builders Federation by the University of Westminster et al. (2002), suggested that planning issues are very much a secondary constraint on development.

It is highly likely that the UK planning system does create some constraint on the supply of residential land in the short term. In turn, it is predicted that this will have some impact on increasing land prices. The magnitude of this effect, however, is likely to be relatively small.

4.5 The future – building more houses

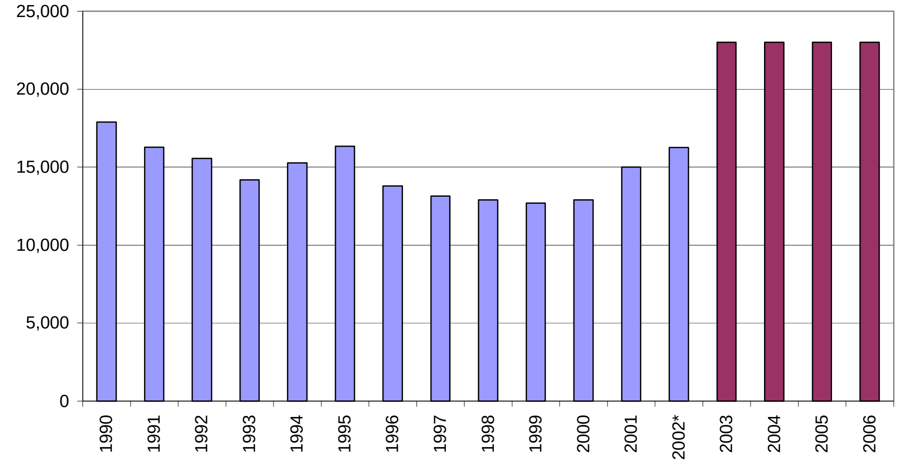
How can London increase the supply of housing?

The key policy points to be drawn from the discussion in this chapter must be concerned with what can be done to increase the supply of housing in London in the future.

The draft London Plan includes house building targets
The draft London Plan outlines targets for house building to 2016. This entails seeking to achieve and exceed 23,000 additional homes per year, built in accordance with urban design and density policies, as well as affordable housing policies detailed in the draft London Plan. In addition, the Plan seeks to promote the efficient use of the existing stock, by reducing the number of vacant, unfit and unsatisfactory dwellings through borough empty property strategies.

In order to achieve these building targets a step change in the amount of house building is required compared to recent years. In order to achieve this significant change a variety of measures may need to be adopted. This may need to include speeding up the processing of planning applications, improving the resourcing of planning departments, encouraging the increased use of prefabrication methods, and measures to address skills shortages in the construction industry.

Figure 4.5: Housing provision – London
(number of housing completions 1990-2002 and London Plan targets 2003-2006)



Source: ODPM Housing Statistics
* 2002 figure is an estimate

There are current concerns however, about the speed of delivery of new housing in the capital
A recent report commissioned by the GLA and the House Builders Federation (2002) considered at length what is needed to speed up the delivery of new housing for London and touched on a variety of issues.

Practical site problems are the main reason for allocated housing sites not being developed…
It looked at the main reasons for the failure of some sites allocated for housing development in Unitary Development Plans to be taken forward by developers.

In most cases this was due to very practical factors such as physical site difficulties, high infrastructure costs or site assembly/ownership problems. Both planning officers and property professionals tend to believe that there are no easy development sites in London any more.

…but affordable housing requirements seem to be being accepted
Specific planning policies were also cited as a problem, but developers only occasionally cited affordable housing requirements as a deterrent to development. It would seem that most developers now accept that an affordable element is inevitable and land values adjusting accordingly.

Time taken to process planning applications does delay development…
The other main area the study covered was the time taken to process planning applications causing delay to development. It found that 60-75 per cent of schemes were processed in under six months but that in some cases processing took considerably longer.

…but the main problems are associated with the under-resourcing and under-staffing of planning departments
The key problems that emerged were:
- under-resourcing and under-staffing in planning departments
- protracted pre-application and planning obligation negotiations
- a need for a clear, standardised approach in preparing and dealing with applications.

Pre-fabricated methods are touted as a means of speeding up delivery…
The increased use of pre-fabricated methods is now being widely discussed as a solution to improving efficiency in the house building industry. The Construction Industries Task Force (DETR, 1998) chaired by Sir John Egan outlined the vital need for improvements in productivity and reductions in construction time in the industry.

Pre-fabricated methods of construction seem to offer the potential for efficiency gains, helping to speed up delivery. Yet bad experience with systems building in the 1960s has unquestionably provided a mental barrier for house builders and buyers, discouraging the re-adoption of such methods.

It is the social housing sector that is now being encouraged to use new systems of pre-fabrication through the Housing Corporation's approved development programme. It the past there has also been concern about whether there will be sufficient sustained demand to maintain factories producing pre-fabricated units. The housing targets outlined in the draft London Plan to 2016 suggest that demand for pre-fabricated units could indeed be sustained over the long term.

…but shortages of skilled labour may prove to be a problem
Skills shortages in the construction industry in London have been described as chronic by the London Development Agency which recently announced a new programme of action to tackle such skills shortages: the London Framework for Regional Employment and Skills Action (FRESA). The scheme aims to help to supply the 10,000 skilled construction staff ranging from qualified engineers to bricklayers that will be needed annually to deliver London's key building projects, such as the National Stadium and the developments in Thames Gateway.

The number of big construction projects in the pipeline in London is considerable, and there is the potential that shortages in skilled labour in the industry may prove a considerable headache for the residential construction industry in London over the next few years.

5. Affordability

5.1 Introduction

> In London there is an urgent need for more affordable homes all over the capital to accommodate London's growing population and to reduce homelessness. These need to be built to a high standard of design so that they enhance and sustain communities. We must also ensure that workers who are key to the delivery of the capital's public services are able to afford to live and work within its communities. ODPM (2003)

Affordability has become the key London housing issue
Affordability is currently perhaps the most discussed issue of housing market failure in London. Whilst historically affordability has been more of an issue in London than for the rest of the country – it has always been difficult for someone on average earnings to buy a property – it has become a top priority for central and London government. As the Mayor's Housing Commission report stated in 2000, 'the impact of a shortage of affordable housing is felt by a widening number of Londoners and is impinging on London's economy.' Since then this shortage has if anything worsened.

It has a variety of dimensions, affecting owner occupied and rental sectors…
Affordability has been defined in a variety of subtly different ways and has a variety of dimensions. For the purposes of this report, it is first useful to separate out affordability in the owner-occupied and rental sectors as trends in these different sectors have varied. The prime area of current concern in the capital, however, is affordability in owner-occupied property.

…first-time buyers, existing households and key workers
Within the private owner-occupied context there are two main strands to defining affordability[19], which are:
- the ability of a first-time buyer to purchase a property
- the ability of households to sustain mortgage payments/home-ownership.

This chapter includes sections addressing the specific issues relating to first-time buyers and key workers.

The overriding issue is the shortage of affordable homes
However, the overriding issue is an absolute shortage of affordable homes for rent and for purchase for first-time buyers and key workers. This chapter ends with a brief outline of some of the policy approaches available to tackle this shortage.

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[19] See Garratt (2000)

5.2 The owner-occupied sector

In London the affordability of housing in the owner-occupied sector has been declining

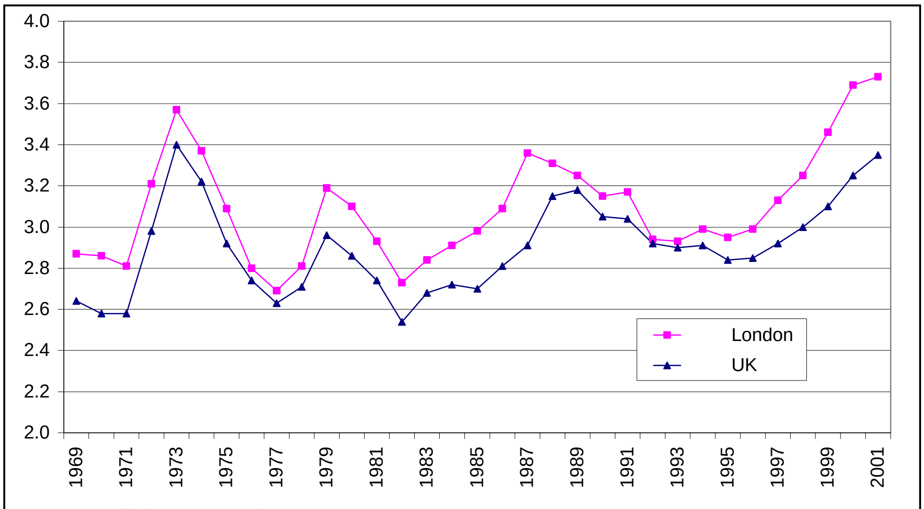
The affordability of housing in the owner-occupied sector decreased in the late 1990s because of escalating house prices[20]. This trend has continued through to 2002, but is likely to have moderated so far in 2003 with house price growth declining considerably.

As there are a variety of ways of looking at affordability, a variety of indicators can be constructed to investigate the issue. These indicators include the house price to income ratio (HPIR), the house price/earnings ratio (HPER), the advance to income ratio (AIR) and the mortgage cost to income ratio.

House Price to Income Ratios have been on the increase since the mid 1990s…

Figure 5.1 shows the pattern of HPIR over the past three decades according to data from the Council of Mortgage Lenders. It indicates clearly how the affordability of housing in the owner occupied sector in London has fallen since the mid 1990s as a result of escalating house prices.

Figure 5.1: House price to income ratios – London and UK (1969-2001)



Source: Council of Mortgage Lenders

…and have reached historically high levels

Indeed house price to income ratios in London are at historically very high levels, and since 2001 will have risen even further. With average London house prices now static in 2003, the growth trend in the HPIR may well now have come to an end for the present.

House price to earnings ratios provide very similar trends. According to research carried out by Barclays in December 2002, property prices in 31 of the 33 London boroughs have now risen to over seven times earnings. They suggest that the highest ratio is in Kensington and Chelsea where property prices (averaging £663,506) are now 18 times local earnings despite the borough having the highest incomes in the country.

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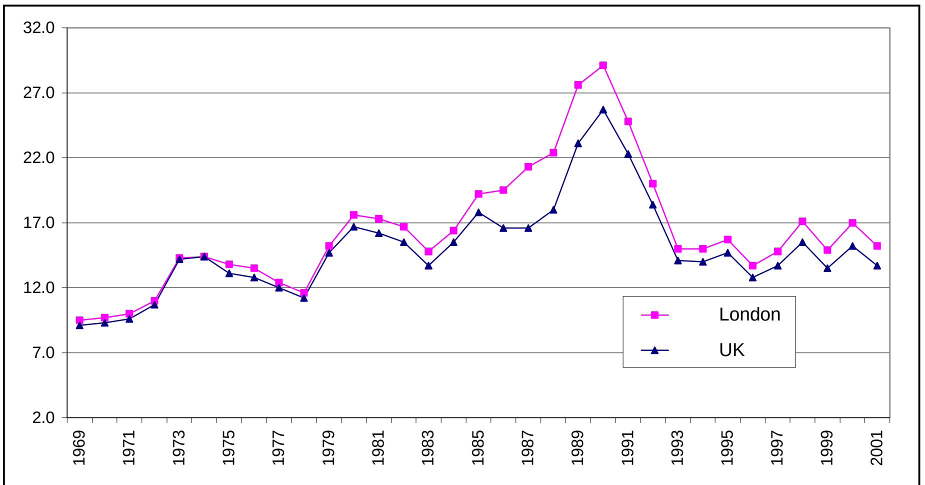
[20] See Garratt (2001)

For most owner-occupiers mortgage repayments remain affordable…
The relationship between income/earnings and property prices is clearly not everything in terms of affordability, since those who already own property have to some extent benefited from increased property prices.

With interest rates currently at such low levels, as shown in Figure 5.2, mortgage interest payment to income ratios remain moderate, despite property prices being high. In other words, for those already owning property, the costs of servicing mortgage debt remains at reasonably low levels. This is in strong contrast with the end of the last property boom in the late 1980s when interest rates and mortgage repayments reached very high levels.

Figure 5.2: Mortgage interest payments to income ratios – London and UK (1969-2001)



Source: Council of Mortgage Lenders

…the problems amongst existing home owners lie with those seeking to buy bigger properties
Reports from some of the main mortgage lenders have suggested that house price rises during 2002 have meant that many homeowners seeking to trade-up have been finding that they cannot afford to do so. Despite experiencing significant equity gains in recent years London homeowners have been finding the price jump up to a bigger property is increasing.

This is confirmed by the latest data from the Council for Mortgage Lenders regarding advances and deposits. The advance to income ratio (AIR) in London has also been on the increase, whereas nationally it has remained fairly constant and similarly the deposit to income ratio in London has increased at a faster rate than across the UK as a whole. It is first-time buyers however, who have been disproportionately affected by these trends however.

5.3 First-time buyers

Affordability issues are particularly affecting first-time buyers
There is a wide range of evidence available to suggest that at the present it is first-time buyers that are being most affected by affordability issues.

First-time buyers account for a declining proportion of mortgage lending…
The proportion of lending to first-time buyers has been declining steadily for the last few years, almost certainly reflecting increased affordability constraints as a result of rising house prices. Recent figures on lending for house purchase show that in the first two months of 2003 less than a third of lending across the UK has been to first-time buyers. This compares with a long run trend of around 45 per cent.

…particularly in high priced areas such as London
The average loan to first-time buyers has also fallen significantly in the first two months of 2003 compared to 2002, adding further to indications of a slowdown in activity amongst first-time buyers in the highest priced areas of the UK such as London.

London first-time buyers spend more of their income on mortgage payments than elsewhere in the UK
Recent research by Nationwide (September 2002)[21] outlined some of the problems faced by first-time buyers in London. Over the past few years, mortgage payments as a proportion of take home pay have risen much higher in London (65 per cent) than the UK average (40 per cent). With interest rates currently at such low levels, the reason for this situation is not high mortgage interest rates, but high house prices, and has been generated by the recent rapid growth in house price inflation.

Whilst mortgage repayments as a proportion of income for first-time buyers were close to average in 2002…
As can be seen in Figure 5.3, for a first-time buyer in London in 2002 initial mortgage payments as a proportion of income were in fact close to their average over the last 25 years. In most other UK regions they were considerably below average.

…still below the excesses of 1988…
So with interest rates low, mortgage repayments for first-time buyers in London are still below the excesses recorded in 1988 when they exceeded 100 per cent of take home pay for someone on average earnings.

…substantial deposits are being required…
Figure 5.3 also shows the ratio of what a person on average earnings would need to borrow compared with what they are typically able to borrow (assumed 3.5 times gross earnings). When the ratio goes above 1 then either buyers need to persuade lenders to advance more than the standard 3.5 times income multiple, or a 5 per cent deposit is no longer enough in order to be able to buy the average house.

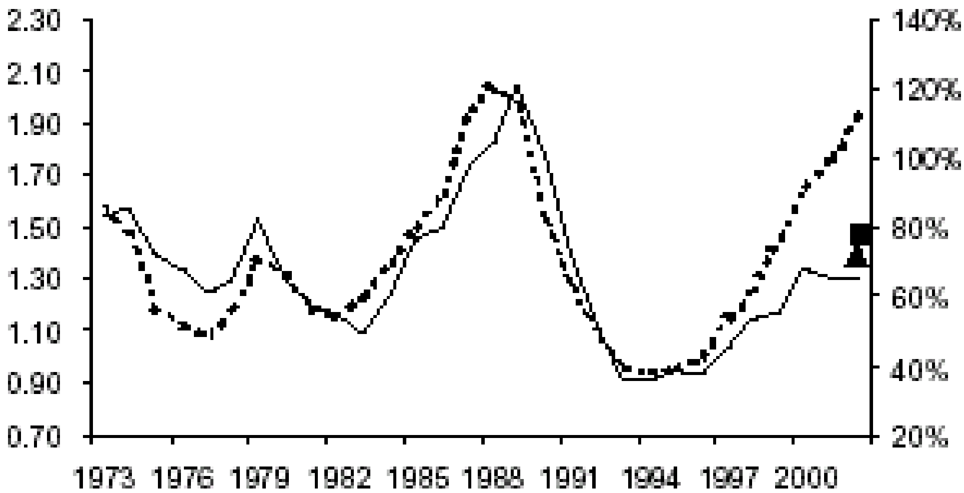
21 Nationwide (2002a)

According to the Nationwide research, this ratio is now heading towards 2, almost reaching its 1988 level. This suggests that in order to get a foot on the property ladder first-time buyers require substantial deposits .

Recent research by Halifax[22] suggests that an average first-time buyer in London now makes a deposit of over £41,000 (22 per cent of the property value) to buy their first home.

...squeezing first-time buyers out of the housing market
Given this evidence it is hardly surprising that first-time buyers are accounting for a decreasing proportion of mortgage lending in London as fewer are able to afford the levels of deposit required.

Figure 5.3: London affordability for first-time buyers (% of disposable income)



Source: Nationwide, ONS and OEF/NIERC

- - - - - - Ratio of advance needed to buy an average first-time buyer property (assuming 5 per cent deposit) to 3.5x gross earnings (as shown on left-hand scale)

——— Mortgage payments as per cent of disposable income (as shown on right-hand scale)

■ Mortgage payments if base rates = 6 per cent (mortgage rate = 7.5 per cent) (as shown on right-hand scale)

▲ Mortgage payments if price increased by a further 10 per cent (RHS)

With continuing price rises at the lower end of the market affordability is being stretched further…
Since the Nationwide research was carried out last year, price rises at the lower end of the market have risen further and affordability for first-time buyers will have been stretched further.

[22] Halifax (2003)

…which may finally be having an impact on house price growth

The triangular marker on Figure 5.3 shows the impact on initial mortgage payments for a first-time buyer of an immediate increase in house prices of 10 per cent (close to what has actually happened over the past six months). This scenario pushes mortgage payments up towards 80 per cent of disposable average employment income (though interest rates have also been cut marginally). It is not surprising that house price growth is showing significant signs of slowing.

5.4 Houses for key workers

Affordability issues for key workers provide government with particular cause for concern

Within the debate about affordability there has been a particular focus on the problems key workers are having in purchasing property in London and the South East. The potential impact of continuing affordability issues for key workers such as nurses and teachers is increasing shortages of staff for hospitals and schools. In response, in July 2002, the government announced measures aimed to help key workers to buy a home as part of the Comprehensive Spending Review.

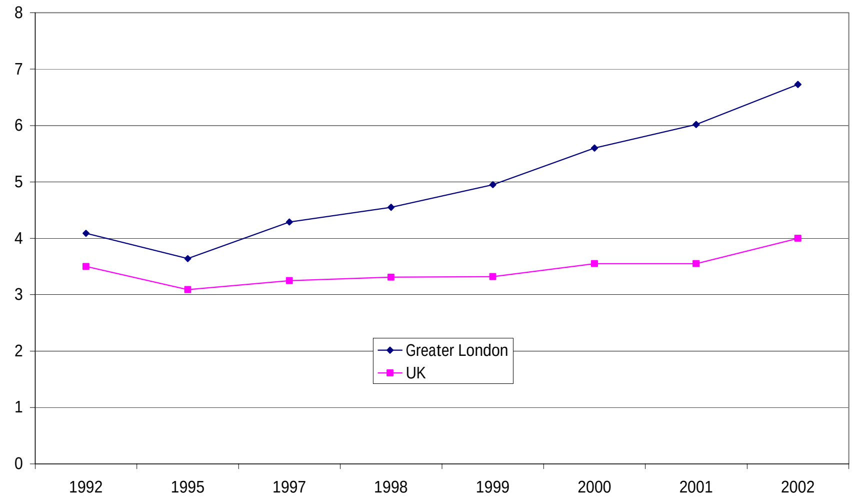
The situation has worsened over the past few years

Research carried out by Halifax in July 2002 investigated housing affordability over the last ten years for four key public sector groups: nurses, teachers, police officers and fire fighters. London and the South East have consistently been the most difficult regions for people in these occupations to buy their own home over the last decade, but the situation has worsened over the past few years.

The average London house costs almost seven times a teacher's average annual salary…

Looking specifically at teachers, in London the average price of a property now stands at almost six and three quarter times a teacher's average annual pay, compared with just over four times ten years ago. The Halifax research also shows it would require an increase in teachers' average earnings of from £29,020 to £47,775, to restore the relationship between house prices and teachers' pay that was apparent in 1992.

Figure 5.4: House price: earnings ratio for teachers (1992-2002)



Source: Halifax

…and almost nine times a nurse's average annual salary

The same pattern is apparent for nurses, fire fighters and police offices over the past decade. In London, the average price of a property now stands at 8.6 times a nurse's average annual pay compared with 5.25 times, ten years ago. For fire fighters the ratio has risen from 4.3 to 7.7, whilst police officers have fared somewhat better with an increase in the ratio of prices to average earnings from 3.5 in 1992 to 5.3 in 2002.

Table 5.1: House price earnings ratios for key workers

	1992	1995	1997	1998	1999	2000	2001	2002
Great Britain								
Nurses	4.97	4.37	4.46	4.63	4.64	4.71	4.82	5.42
Teachers	3.50	3.25	3.09	3.31	3.32	3.55	3.55	4.00
Police Officers	3.01	2.69	2.79	2.82	2.87	3.08	3.15	3.54
Fire Fighters	4.88	4.04	3.94	4.24	4.11	4.51	4.80	5.41
London								
Nurses	5.25	4.73	5.41	5.97	6.38	7.02	7.69	8.59
Teachers	4.09	3.64	4.29	4.55	4.95	5.60	6.02	6.73
Police Officers	3.50	3.15	3.69	3.84	4.12	4.71	4.77	5.34
Fire Fighters	4.28	3.83	4.18	4.77	5.06	6.10	6.93	7.74

Source: Halifax (2002)

Affordability is a problem for key workers in the South, but not in the North…

It is important to note that the situation is very different in northern Britain. Housing is actually *more* affordable for nurses, teachers and police officers in the North, Yorkshire and the Humber, the North West and Scotland than it was ten years ago. For example, the average house price in the North currently stands at 3.3 times an average nurse's annual pay compared with 4.6 times pay in 1992.

…and it is clearly affecting public sector recruitment

There is plenty of anecdotal evidence to suggest that housing problems are a major factor in the recruitment crisis in both education and the health service. Local authorities are reporting recruitment problems in the public services throughout London and the South East. Indeed report in the Nursing Times in 2002 suggested that as many as a quarter of nursing positions in London are currently vacant.

5.5 The rental sector

Affordability in the rental sector has received less attention

Affordability issues in the rental sector have received little attention compared to the owner-occupied sector and thus little research or data is available.

Private sector rents as a proportion of average incomes increased throughout the 1980s and 1990s…

Private sectors rents as a percentage of average incomes increased substantially throughout the 1980s and 1990s across the UK[23]. Balchin and Rhoden (2002) observe that under the Housing Act of 1988, fair rent tenants were being increasingly brought into the assured tenancy or assured shorthold system (with minimum letting of only six months), whilst tenants suspecting that their rents might be above the market level lost their right to refer the matter to the Rent Assessment Committee.

…as have Local Authority and Housing Association rents.

Local authority housing rents as a proportion of average incomes also rose rapidly in the 1980s and 1990s. The privatisation of much of the local authority housing stock has had some impact on this as the loss of older stock has reduced the extent to which newer high-cost council housing can be cross-subsidised through the process of rent pooling[24].

Housing association tenants have similarly experienced an increase in rents as a proportion of incomes. The Housing Act of 1988 required an increasing proportion of capital expenditure in this sector to be funded by private institutions and rents have risen to ensure a competitive return on investment.

Average rents in all sectors now exceed 25 per cent of the net income of the head of the household

In the early 1990s, an affordable rent was defined by the National Federation of Housing Associations (NFHA) as below 25 per cent of the net income of the head of a household. According to this definition, rents in all sectors became no longer affordable by the late 1990s.

5.6 The future – tackling affordability

There are a variety of policy approaches to improving affordability.

There are a variety of ways in which governments can tackle housing affordability issues both directly and indirectly. Direct intervention in the housing market is no longer on the agenda in the current political climate in the UK, so capping rents or house prices are not a considered option.

Some indirect ways in which central government can help to tackle affordability include:

- introducing a more effective system of housing benefit
- introducing a new form of housing allowance targeted at low income home owners
- bolstering schemes designed to facilitate home ownership amongst those with low-incomes (eg subsidised shared ownership)
- increase taxation on empty homes
- scrapping the Right to Buy scheme.

[23] Wilcox (2000)
[24] Balchin and Rhoden (2002)

The Mayor's Housing Commission outlined a portfolio of policies necessary to meeting London's affordable housing requirements and included:

- tackling empty properties
- stemming losses from the existing stock of affordable homes
- a programme of open market acquisitions to meet housing needs
- modernising the private rented sector so it can make as large a contribution as possible to London's needs
- providing mobility opportunities for tenants.

There are a variety of schemes to facilitate home ownership amongst those with low-incomes

There are now a variety of schemes in place in London to facilitate home ownership amongst those with low-incomes. The Starter Home Initiative (SHI) for example made £250 million available nationally to help house 10,000 key workers over 2001-04.

…but increasing the supply of social and owner-occupied housing is the most effective option over the long term

However, policies that offer subsidies have a tendency to underpin or inflate rents or house prices, so in the long term the most effective way of ensuring an adequate future provision of affordable housing is simply through building more social and owner-occupied housing.

There is a shortage of all types of houses…

Over the long term, given the general undersupply that has taken place in the South East over a prolonged period, it is building more housing (of all types) that matters. Indeed there are strong arguments for ensuring the supply of high quality (more expensive) housing in many areas of London that are seeking to regenerate themselves, particularly in the Thames Gateway area.

…but more affordable properties and assisting those on lower incomes is the short term priority

However, the shortage of affordable properties is the more pressing issue. In order to address affordability issues swiftly, not only is building more social/affordable housing a priority, but some subsidies are almost certainly necessary to ensure that not only key workers, but those on low to intermediate incomes can afford to live in the capital.

The draft London Plan contains some clear goals with regard to affordable housing

The draft London Plan defines affordable housing as comprising social housing, intermediate housing, and in some cases, low cost market housing. In the draft London Plan, the Mayor has set a strategic target to increase the provision of affordable housing in London, which would result in about 10,000 affordable homes per year based on research by Three Dragons/ Nottingham Trent University[25]. The target is that 50 per cent of all new dwellings in London should be affordable, though the target in 35 per cent in 13 of the 33 boroughs.

The draft London Plan also recommends that in reviewing UDPs boroughs should adopt these affordable housing targets for negotiating affordable housing in individual schemes.

[25] Three Dragons/Nottingham Trent University (2001)

Private residential developers are expressing concern

Private residential developers have expressed considerable concern about these targets. The key question is whether a demand for affordable housing on a site, in line with these targets, will depress residual value and the amount that a developer is prepared to pay a landowner to such an extent that the landowner withholds land from the residential market.

London residential land transaction levels are probably low and this situation is likely to continue

Assessing whether this is the case is exceedingly difficult and the Three Dragons/Nottingham Trent University model has provided a useful framework for addressing the issue.

Recent official data suggests that land transaction levels in London are currently at relatively low levels. Given that lower land price growth rates are likely over the coming years, low transaction levels are likely to continue.

Looking at a period in London when private sector residential land prices were increasing rapidly, such as 1986 and 1987, 124 and 110 transactions took place in those years respectively, according to data from the ODPM. This compares with provisional figures of 11 and eight transactions for 1999 and 2000 respectively, the two most recent years for which London data is available.

Conclusion

Economists consider the market for housing as highly complex, a web of varying geographical and housing type sub-markets. They also suggest that housing is rife with market failure.

At the present time, there is ample evidence of failure in the London housing market. There are serious consequences of the unresponsiveness of supply to growth in demand and major fluctuations in house prices, and housing related issues represent some of the most fundamental problems currently affecting the London economy and the lives of its residents.

There are numerous aspects to housing market failure, but the most substantial issue for London – and that largely addressed in this report – is the underlying shortage of housing. Over recent years the demand for housing has been outstripping supply, resulting in house prices rising dramatically. In particular there is a shortage of housing for those with lower incomes – affordable housing – with social housing waiting lists on the increase.

Economics is concerned with the way in which scarce resources are used to produce the goods and services that satisfy material wants. Land as a resource is available in limited supply and in London and the South East of England in particular there is a prevailing perception of a shortage of land.

Any survey of people's ideal housing wants is likely to reveal a desire for extensive living space. In areas where there is a plentiful supply of cheap land, the single storey bungalow is likely to prevail. The paradox is that at the same time many people do not wish to see the continuing urbanisation of Britain, resulting in policies discouraging house building on greenfield land (powerfully advocated by the influential Campaign for the Protection of Rural England).

The solutions to this include using land more intensively by increasing housing densities, bringing brownfield land (in some cases derelict or polluted) back into use for new housing, ensuring there are fewer homes standing empty, and converting more non-residential buildings to residential use. All these policies feature in the draft London Plan. One further solution, which is explicitly excluded by the draft Plan, is the selective use of London's Green Belt for house building.

In allocating resources, societies pursue a variety of objectives. Economists focus particularly on efficiency and equity. Looking at the supply of housing, an efficient outcome would involve the balancing of supply and demand in any particular housing sub-market.

Yet the overall supply of housing in London has been in decline since the late 1960s, with no corresponding decline in demand. If anything, demand has increased since that period. There is strong evidence to suggest that since the Second World War the private housing market has consistently not supplied sufficient housing to meet demand.

House building is a risky business due to fluctuations in house prices and the time lag between land purchase and the completion of any housing development. The structure of the industry in the UK, with its predominance of small firms, contributes to a tendency towards being risk averse. In addition, there will always be a proportion of the population unable to obtain adequate housing for themselves due to income limitations. It is unlikely that the market will meet their requirements so there is a need for government to intervene to correct an inequitable distribution of housing.

For decades the shortfall in the provision of housing was compensated for by council house building programmes. The primary reason for the decline in the supply of housing has been the dramatic reduction in the level of direct government intervention in the market through falling levels of construction of social housing. The decline in supply has therefore been largely at the affordable end of the market.

Indeed a large part of the reason for government intervention in the housing market is for reasons of equity rather than efficiency, in order to guarantee a minimum level of provision. The traditional housing objective in this country has always been providing a decent home for every family at a price within their means. This continues explicitly with the government's decent homes standard, seeking to reduce the number of non-decent homes in council ownership to zero by 2010.

Yet policy objectives can easily become confused and there is a long history in the UK of new housing policies being applied to correct the failures of previous policy. The 1980 Housing Act introduced the Right-to-Buy policy, giving council tenants a statutory right to buy their council property. The government claimed its reforms at that time were to address the inefficiencies and inequities of council housing, which were resulting in cumulative neglect in repair and maintenance of many council housing estates. People on low incomes were to be encouraged to become more self-sufficient through owner-occupation. Whilst the policy proved to be enormously popular, there is little question that it has reduced the availability of decent accommodation for more recent generations of tenants in real need. Critics have argued that it has been the better-off tenants who have become owner-occupiers, with council housing increasingly becoming a residual welfare sector, perhaps even increasing inequality and social polarisation.

The main challenge now facing London and central government policy makers is how to address the consequences of both housing market and past policy failure to ensure that a significant step change in house building takes place in London and its surrounding regions. In particular, there is an urgent need to address the shortfall in affordable homes.

The draft London Plan clearly seeks to address these issues, with its minimum targets for new house building and proportional targets for affordable housing. The ambition of the draft London Plan and the government's Communities Plan is clear.

Questions remain however as to whether these ambitions are achievable. Are housing associations equipped to succeed in delivering a significant step change in their levels of house building? Will private developers step up their levels of building with stringent, less profitable, affordable housing requirements? Will developers be able to improve productivity and speed up the delivery of new housing? Are the London borough planning offices well enough resourced to handle increased volumes of residential planning applications? Will labour shortages in the construction industry prove to be a problem? And will a crash in London house prices scupper policy makers best intentions?

This report has sought to provide an overview of the issues relating to market failure in the London housing market. Inevitably it uncovers as many questions as it answers. In particular, there are some clear gaps in understanding relating to the under-supply of housing in response to rising house prices.

The government has recognised the key economic importance of this subject, commissioning a report from Kate Barker of the Bank of England's Monetary Policy Committee to review the issues affecting the supply of housing in the UK. In particular, it will focus on:

- the role of competition, capacity and finance of the house-building industry
- the interaction of these factors with the planning system and sustainable development objectives
- identifying appropriate options for government action, including the use of fiscal instruments.

The Chancellor has also asked Professor David Miles to investigate the provision of long-term fixed rate mortgages.

The results of this research should be important and timely. There is room, however, for more work on this subject with a specific focus on understanding these issues at a London level.

Appendix: House price data sources

Introduction

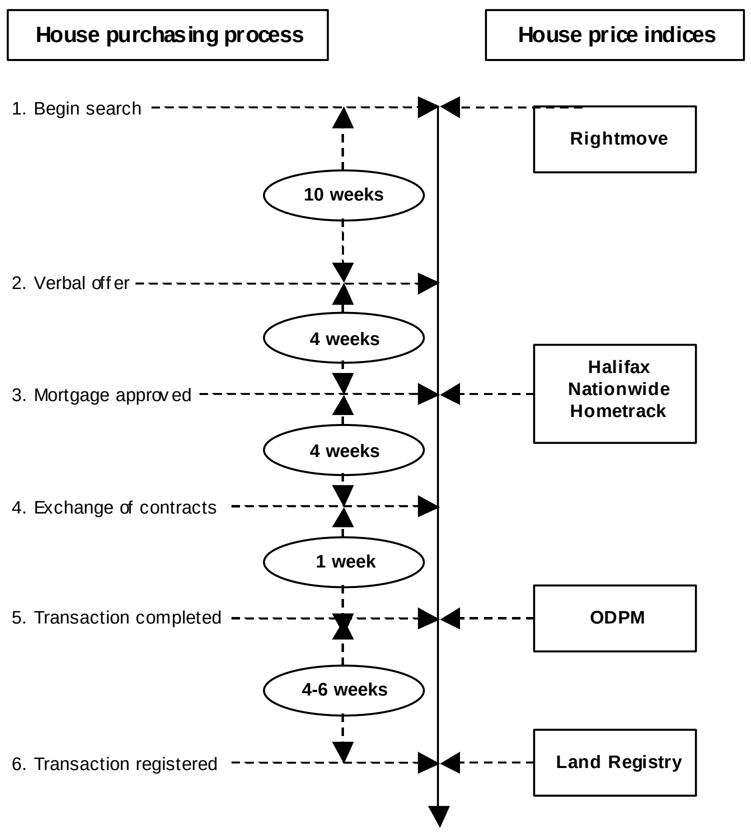
There are a number of measures of UK house prices now available. The longest established UK house price indices are those produced by the Land Registry, the Office of the Deputy Prime Minister and the mortgage lenders Nationwide and Halifax. The housing websites Hometrack and Rightmove also produce indices, with Hometrack focusing in particular on London. FPD Savills produces an index of prime central London residential capital values.

In addition, there are also surveys of professional's views of changing house prices, carried out on behalf of the Royal Institute of Chartered Surveyors and the House Builders Federation.

House price indices compared

Each of the available measures calculates house price indices in a different way. Figure A.1 provides a useful summary of the point in the house purchasing process at which information for each of the indices is taken.

Figure A.1: House purchase timeline and house price indices



Source: Bank of England Quarterly Bulletin, Spring 2003

Indices nearer the beginning of the timeline are likely to detect a change in house prices first. However, as the sale price of any house will change from the point at which it is first advertised to the point of completion, those further along the timeline are more likely to reflect actual prices.

Land Registry

As the Land Registry index is based on a 100 per cent sample of housing transactions in England and Wales, its Residential Property Price Report provides the most authoritative dataset of average house prices and sales volumes. The index is not mix adjusted however, so variations in the mix of type of property bought and sold will affect the level of the index. The report offers average price and number of sales data by individual borough, but only back to 1995. Quarterly data is available for London as whole, with borough data available on an annual basis.

Halifax and Nationwide

Both mortgage lenders produce house price surveys based on the valuations of properties shown on approved applications for mortgages. Application forms contain sufficient information to allow for quite detailed breakdowns. The monthly information is standardised (weighted) to eliminate distortions caused by different types of properties being bought from one month to the next. The main difference between the two indices is the way in which this weighting is carried out. The Halifax index is based on the characteristics of the average house on which they approved mortgages in 1983, whilst the weights for the Nationwide index are derived from rolling averages of the Survey of Mortgage Lenders, Land Registry and Nationwide samples. A more detailed comparison of the two indices is available in the Bank of England's Quarterly Report, Spring 2003.

Both mortgage lenders publish London results quarterly. Nationwide has historical data back to 1973 and Halifax back to 1983.

ODPM

The ODPM index is a weighted average of prices for a standard mix of dwellings and is based on a 5 per cent sample of Council of Mortgage Lenders' completions. London data is available back to 1969, though the precise method of standardising the data has changed over that period. The current weighting method has been consistent since 1993. In 2003, the ODPM is set to improve its coverage of UK house price change by launching a monthly ODPM House Price Index Statistical Release and a new quarterly ODPM House Price Report.

Hometrack and Rightmove

Hometrack.co.uk and Rightmove.co.uk are recent additions to the survey data available, and therefore both have no historical data to speak of. They are both providing data based on Estate Agents reports; Hometrack from around 4,000 estate agents and Rightmove from 2,900. The significant difference is that Rightmove provides data based only on asking prices, whilst Hometrack (like Nationwide and Halifax) provides data based on mortgage approvals.

Hometrack has a particular London focus and has had considerable press coverage for a new survey. It claims to be the most comprehensive and up-to-date survey of the London housing market undertaken – with an estimated sample size representing half of the total market (collected monthly from 900 estate agents in London). Hometrack covers a wider range of data including house prices (by type of house), number of sales, growth in buyers and registered properties for sale.

Royal Institution of Chartered Surveyors

The RICS Housing Market survey is simply a survey of trends – asking about 350 chartered surveyors whether house prices have gone up, down, or stayed the same during the past quarter compared to previous quarter.

FPD Savills

The Prime Central London Residential Capital Values Index is a quarterly index of house prices in central London based on the regular valuation of a standard portfolio of properties. The portfolio is reviewed roughly every five years to keep it representative. The index base date is June 1985.

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Hindi

यदि आप इस दस्तावेज़ की प्रति अपनी भाषा में चाहते हैं,
तो कृपया निम्नलिखित नम्बर पर फोन करें अथवा दिये
गये पता पर सम्पर्क करें।

Vietnamese

Tiếng Việt
Nếu bạn muốn bản sao của tài liệu này bằng ngôn ngữ của bạn, hãy gọi điện theo số hoặc liên lạc với địa chỉ dưới đây.

Bengali

আপনি যদি আপনার ভাষায় এই দলিলের প্রতিলিপি
(কপি) চান, তা হলে নীচের ফোন্ নম্বরে
বা ঠিকানায় অনুগ্রহ করে যোগাযোগ করুন।

Greek

Αν θα θέλατε ένα αντίγραφο του παρόντος εγγράφου στη γλώσσα σας, παρακαλώ να τηλεφωνήσετε στον αριθμό ή να επικοινωνήσετε στην παρακάτω διεύθυνση.

Urdu

اگر آپ اِس دستاویز کی نقل اپنی زبان میں چاہتے
ہیں، تو براہِ کرم نیچے دیئے گئے نمبر پر فون کریں
یا دیئے گئے پتے پر رابطہ قائم کریں.

Turkish

Bu brosürü Türkçe olarak edinmek için lütfen asagidaki numaraya telefon edin ya da adrese basvurun.

Arabic

إذا أردت نسخة من هذه الوثيقة بلغتك، الرجاء
الاتصال برقم الهاتف او الكتابة الى العنوان
أدناه:

Punjabi

ਜੇ ਤੁਹਾਨੂੰ ਇਸ ਦਸਤਾਵੇਜ਼ ਦੀ ਕਾਪੀ ਤੁਹਾਡੀ ਆਪਣੀ ਭਾਸ਼ਾ
ਵਿਚ ਚਾਹੀਦੀ ਹੈ, ਤਾਂ ਹੇਠ ਲਿਖੇ ਨੰਬਰ 'ਤੇ ਫ਼ੋਨ ਕਰੋ ਜਾਂ ਹੇਠ
ਲਿਖੇ ਪਤੇ 'ਤੇ ਰਾਬਤਾ ਕਰੋ:

Gujarati

જો તમને આ દસ્તાવેજની નકલ તમારી ભાષામાં
જોઈતી હોય તો, કૃપા કરી આપેલ નંબર ઉપર
ફોન કરો અથવા નીચેના સરનામે સંપર્ક સાધો.

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