Preparing for Recovery
Maximising House Building Growth in the Upswing

Home Builders Federation (HBF)
August 2009

Home Builders Federation
1st Floor
Byron House
7-9 St James's Street
London SW1A 1EE

T: 020 79601600

CONTENTS

KEY RECOMMENDATIONS

Most of the new housing required over the next decade will have to be delivered by private housing developers building homes for sale to owner occupiers or private rental investors. Below are our key recommendations to enable house building to rise sufficiently in the medium to longer term to meet need and demand.

Because the state controls the supply of permissioned land, has considerable influence over house builders' products and extracts significant land value to fund public policy and regulatory demands, inevitably many of our key recommendations are directed at central and local government.

Mortgage Finance Recovery
An essential pre-condition is a restoration of mortgage availability and a return to more affordable mortgage terms.

Permissioned Land Supply
Local planning authorities should be required rapidly to speed up their preparation of development plans, currently running far behind target; local authorities should be obliged to identify a realistic five-year housing land supply to meet local housing requirements; regional and local planning authorities should not use the current, short-term downturn in house building to cut back on long-term housing land provision; central government should urgently introduce the reforms identified in the Killian Pretty Review.

Homes to Meet Local Need and Demand
Central government should avoid policies which limit house builders' ability to provide densities and types of new homes which people want to buy and live in and can afford to buy; local authority policy and regulatory demands should be sufficiently flexible and realistic to allow house builders to build products which meet local housing demand at affordable prices.

Development Viability & the Cumulative Impact of Policy and Regulation
Central government must make a thorough and realistic assessment of the cumulative impact of all taxation, policy and regulation on residential land values and viability from central government, local authorities and other public agencies – the impact of current and forthcoming polices is incompatible with a significant increase in house building; this will require some difficult policy choices and trade-offs; other sources of funding for many of these policy demands will have to be found, most notably funding for Affordable Housing, community infrastructure and the zero-carbon target for new homes.

Meeting the Housing Needs of First-time Buyers
Because first-time buyers are essential to a healthy housing market, poor affordability and tighter mortgage regulation mean the Government should explore measures to assist young people to take their first step on the housing ladder (e.g. tax breaks for a deposit savings scheme, mortgage interest relief, first-time buyer grants); we recognise the benefits of establishing a supply of professionally managed, institutionally-funded private housing, but the only long-term solution to inadequate rental yields is to ensure there is an adequate supply of housing overall.

1. EXECUTIVE SUMMARY

Britain faces the most difficult housing delivery conditions for decades.

Rapidly expanding household numbers create a pressing need for more homes, yet major demand and supply obstacles stand in the way of increased home building.

Housing Demand and Supply

The official household projections are the most robust guide we have to future housing demand and need. Long-term planning provision for housing should not be altered in response to short-term economic changes.

A number of key indicators show the scale of housing undersupply, and there are many indicators of the adverse consequences of undersupply.

The same solution applies both to alleviating housing affordability, and to reducing the need for Affordable Housing: making sure the total supply of housing is adequate to meet demand and need.

Short-term economic influences (low interest rates, lax lending) fuelled demand in the 2000s, driving up prices. But the primary long-term determinants of house prices are household growth and rising living standards (demand) and housing supply.

Meeting the Government's targets in the timescales envisaged would require house building growth of nearly 20% per year from 2009-16. Post-war growth has never exceeded 5% per year for any extended period.

To achieve completions growth in excess of 5% per year, house builders and suppliers will need to see hard evidence that central and local government and other public agencies are focused on encouraging increased housing output.

Owner occupation is the dominant tenure in Britain (69%) and is the aspiration of eight in ten adults. Since 2000, the private sector has accounted for around 90% of total housing completions. Extremely tight future public spending and borrowing conditions mean the public sector will not be able to fund a large-scale social house building programme. Therefore future house building will need to be predominantly carried out by organisations building homes for sale in the open market.

Maximising Housing Delivery in the Recovery

Local authorities control the supply of permissioned residential land, and central and local government have a major influence over house builders' products and make heavy policy and regulatory demands on residential land value. Therefore the state holds the keys to removing most of the major barriers to housing delivery.

To maximise the rate of growth of private house building, the following issues and obstacles will have to be addressed.

- **Economic Pre-conditions**

A sustained house building recovery will require a restoration of mortgage funding and an end to the recession and house price falls. Britain is expected to experience subdued economic, housing market and mortgage conditions for some time.

- **Permissioned Land Supply and Planning**

House builders cannot build homes without permissioned land.

Local authorities, which alone have legal power to grant residential planning permission, have a critical enabling role to ensure there is an adequate supply of permissioned land for housing.

The development plan system introduced in 2004, which controls the amount of permissioned land, is far behind schedule. Less than 15% of local authorities have a sound, adopted Core Strategy. Annual residential land use has been falling for more than a decade, with a steep fall in greenfield land.

Regional planning bodies and local planning authorities must not attempt to use the recession and fall in house building as an excuse to cut back on land supply and housing provision. Planning is about long-term provision.

- **Housing Mix, Density and Land Requirements**

Average densities in England have risen from 25 dwellings per hectare (dph) in 2000 to a provisional 44 dph by 2008, a 76% rise.

The overall mix and average densities that evolved in the boom, in response to supply and demand influences, are unlikely to be appropriate for the recovery. It will require flexibility and realism from local planning authorities to allow house builders to expand output with densities and mixes that meet local demand.

Based on annual greenfield housing land use from 2000-06, it would take 67 years for new housing to cover an additional 1% of England's land area. Claims that house building is "concreting over the countryside" are absurd.

- **Viability and Regulatory Costs**

The escalating additional costs from policies and regulations planned for the next seven years, on top of existing demands, and set against the sharp fall in land values since mid 2007 and expected fall in average densities, mean that few residential development sites are currently viable. It is likely to be a long time before the land value of many sites recovers to levels sufficient to fund all these demands.

Existing assumptions that residential land values will finance current and planned future housing policy, regulation and taxation are incompatible with achieving high levels of house building. Difficult policy choices and trade-offs are required, and new sources of funding will have to be found for policy demands.

We propose a range of policy and regulation recommendations to help promote a significant increase in housing numbers in the recovery (Section 4.4).

To ensure local authorities have a five-year deliverable, viable housing land supply, they need to work with the industry to make realistic assessments of site viability.

Given the operating environment for UK house builders, greater house building efficiency, cost reductions, new production methods or reduced profit margins do not offer significant sources of funding to cover the costs of policy and regulation.

- **Industry Delivery Capacity**

Home building and supply industry capacity have been seriously reduced by the housing crisis. House building employment has been cut by somewhere between one third and half since 2007, and development finance has been severely curtailed.

Lost capacity will take many years to rebuild, thus acting as a constraint on the speed with which the industry can lift completions.

Because capital is likely to act as a constraint on residential development for some time, partnerships with land owners to reduce capital requirements would seem to offer considerable benefits.

- **Business Models for Housing Delivery**

Traditional UK house builders have usually undertaken all the steps involved in residential development (except rental housing management), so that all the major development risks have to be priced into their profit calculations.

Claims that new types of organisation will need to be brought into housing development often address only some of the key stages in housing development and ignore key risks. Any organisation entering house building would face exactly the same planning, policy, regulatory and other constraints as traditional house builders.

Those who propose alternative business models to traditional house building have a responsibility to explain how these would deal with all the stages and risks in the housing delivery process.

A new model to fund and deliver Affordable Housing is required. Public finance constraints and lack of expertise suggest local authorities are unlikely to be able to make a significant contribution to meeting the housing targets.

- **Meeting the Housing Needs of First-time Buyers & Intermediate Households**

Tighter mortgage regulation and poor affordability will limit access to owner occupation for many more people than before the credit crunch, and social housing provision will be severely constrained. Additional measures will be required to assist first-time buyers (e.g. deposit saving tax incentives, mortgage interest relief, home purchase grants), and it would be desirable to expand the private rented sector.

Because buy-to-let demand is unlikely to recover to pre-recession levels, a professional private rented sector, funded by long-term institutional finance, would offer a valuable alternative source of supply. However adequate institutional rental yields are difficult to achieve from newly built homes because of high capital values.

Most proposals for solving inadequate residential rental yields involve trying to lower capital values and other costs. The planning system should not be used to benefit one particular type of housing provider within one tenure.

The only long-term solution to low rental yields is to ensure an adequate supply of permissioned residential land brings the supply of housing into balance with demand and need – the same as the solutions to poor affordability in the owner-occupied market and escalating Affordable Housing need.

2. INTRODUCTION; THE HOUSING DELIVERY CHALLENGE

Britain faces the most difficult housing delivery conditions for decades.

There is a pressing need for more housing as the number of households expands rapidly. Yet a range of major obstacles stand in the way of increased home building.

The economy, having suffered the worst recession for nearly 80 years, is widely expected to recover only slowly. The supply of mortgage finance and mortgage terms, critical to the ability of young people to take their first step on the housing ladder, are likely to remain tight well into the future.

The long-term undersupply of housing, which stretches back at least three decades, has worsened significantly because of the steep fall in house building since 2007. The amount of land developed annually for housing has been in almost continuous decline since 1994, a sign that the planning system has not been able to provide sufficient permissioned land to meet housing need and demand.

The Government has set an objective for new homes to meet the world's highest environmental standards, while central and local government also require residential development to fund a range of housing-related objectives, such as Affordable Housing, community infrastructure and revisions to Building Regulations. The cumulative cost impact of policy and regulation, both current and future, means many housing sites are not financially viable, and are not likely to be for some years ahead, posing a serious threat to housing delivery. Non-viability, exacerbated by the steep fall in land values since 2007, means other sources of funding will have to be found for the multitude of public policy objectives that would previously have been funded out of residential land values. However this is going to be difficult because public spending and borrowing will be under severe pressure over the next five to ten years.

House building numbers have fallen to historic low levels, yet the need for additional homes is undiminished. Post-war evidence suggests it is very difficult to achieve sustained housing completions growth in excess of 5% per year over a prolonged period. At 5% per year, however, it would be extremely difficult to meet anticipated medium to long-term demand and need, or to achieve the Government's housing targets in the timescales envisaged before the recession.

Therefore we need to consider what the industry, Government, government agencies and local authorities need to do to boost completions growth above 5% per year in the recovery, while at the same time finding ways to meet the Government's environmental standards and housing-related policy objectives. All parties have a crucial role to play.

Four simple propositions lie at the heart of this paper:

Private sector dominant role in housing delivery

- The private sector, in whatever forms, is the only realistic option for delivering the vast majority of new housing required over the next 10-15 years, most of which will be for owner occupiers. And owner occupiers face choices – nine out of ten homes purchased are second hand – so that if buyers do not like, or cannot afford the new home products or prices on offer, they will not buy, and house builders will not build;

Private sector capacity reduced

- Because the current deep recession has drastically reduced house building output and industry capacity, the Government's housing targets are now extremely ambitious on any realistic assumption about housing output growth over the next few years; and house building companies and suppliers will be cautious about future growth plans and capacity expansion;

Public finances constraint on social housing delivery and policy funding

- Public spending and borrowing will be under severe pressure for many years, so that public subsidy for social housing, and public funds for physical and social infrastructure, will be heavily constrained, while reduced land values have sharply cut the land value subsidy previously tapped to provide affordable housing, infrastructure and many other public policy demands;

Enabling private sector delivery the only solution

- Therefore instead of creating ever more complexity and risk for private housing providers, imposing ever greater policy and regulatory demands and costs, and erecting ever higher barriers to housing development, the state must radically review current and proposed future barriers to meeting housing demand and the housing targets. At least in the early years of the recovery, private developers will have to be incentivised to achieve a faster expansion of output than would be possible under current policy and regulatory conditions, whether by curbing current costly policy and regulatory demands, or possibly even through grants or tax breaks.

Many organisations are currently debating the future of housing policy in Britain. This paper is focussed on the critically important issue of new housing delivery. It identifies the major barriers to house building. It also addresses a number of issues which, although sometimes put forward as barriers to delivery, are largely irrelevant, not least because those who propose them appear to have a limited understanding of residential development and the housing market.

The paper avoids straying off into the myriad of other housing policy issues which, however important in their own right, are not directly relevant to housing delivery.

3. SETTING THE SCENE: HOUSING DEMAND AND SUPPLY

3.1 Demographic Underpinnings

The first question to ask is whether current estimates of housing need and demand, which underpin the Government's housing targets for England, are still valid, and whether there is still a major shortfall in housing provision.

It should be noted at the outset that this is not a judgement on the merits or otherwise of national or regional housing targets. The Barker Review[1] in 2004 concluded that we needed a substantial increase in house building. HBF agreed, having produced a report in 2003[2] arguing that Britain was suffering from a serious undersupply of housing, with damaging economic and social consequences. The most recent household projections have raised projected household growth above the rate on which the Government's housing targets were based.

This paper identifies what we believe are the key barriers and constraints to a significant increase in house building, whatever the precise scale of future need, and regardless of whether or not the planning system has formal national or regional targets.

The Government's housing targets for England are grounded in projections of household growth, and in estimates of the scale of housing supply needed to achieve reasonable levels of affordability. The people who will make up the households of the next 10-15 years, all of whom are alive today, have not gone away simply because of the credit crunch.

The only significant area of demographic uncertainty created by the credit crunch is international migration. Around 30% of the projected growth in households in England is attributed to net inward migration. Inward migration may fall because of the recession, so that future net gains may be lower than currently projected. However it is equally possible that outward migration will also fall, given the global nature of the recession, which would increase net gains. Until we have more solid evidence of the impact of the recession on net migration, we should assume the current projections are still valid.

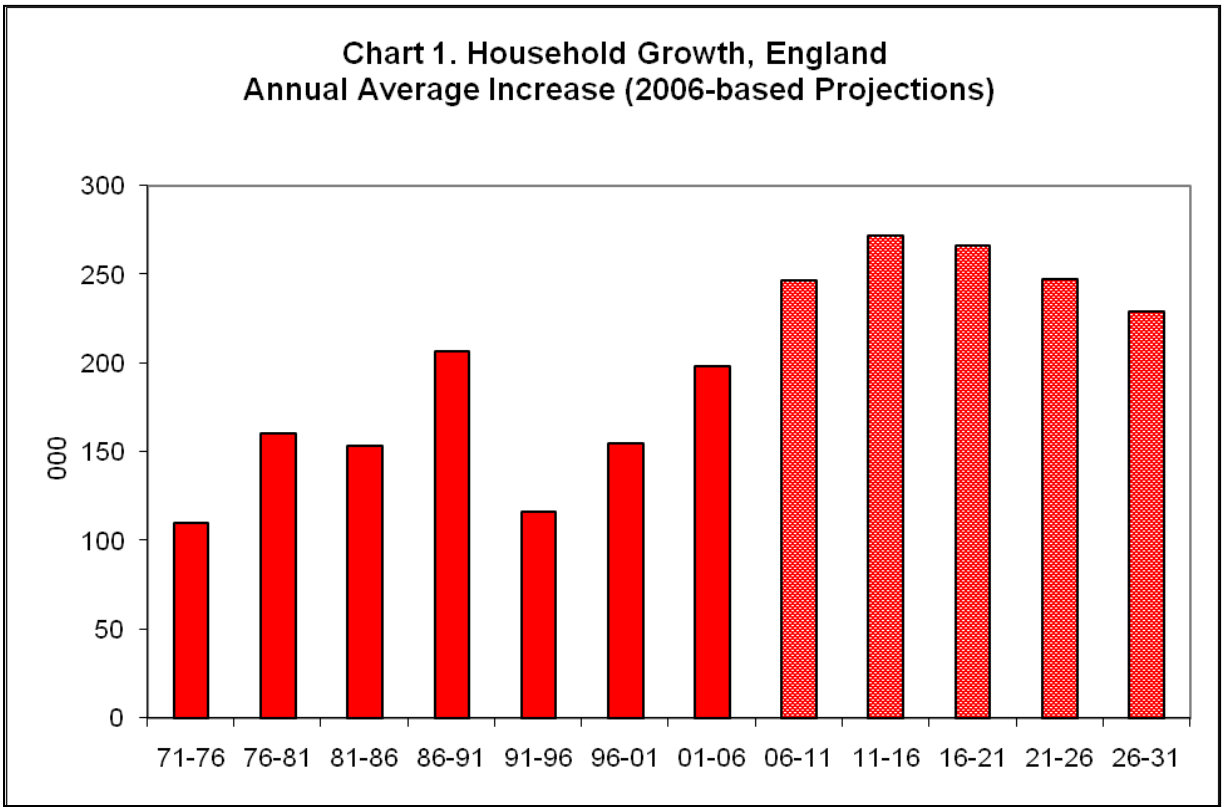
The National Housing and Planning Advice Unit (NHPAU) commented in a recent report:

> "we now expect a faster rate of household growth in the period 2006 to 2026, even after making an allowance for the effect that the recession may have on net migration to the UK".[3]

It should be noted that even on the 'low variant' migration assumption of the 2006-based projections, household growth would be 221,000 per year from 2006-31, still far above current housing provision.

---

[1] Kate Barker. *Review of Housing Supply. Delivering Stability: Securing our Future Housing Needs. Final Report – Recommendations*. HM Treasury, March 2004
[2] John Stewart. *Building a Crisis*. HBF, 2003
[3] NHPAU *More homes for more people: advise to Ministers on housing levels to be considered in regional plans*. July 2009



The recession may influence short-term household formation. For example, fewer young people may leave home to set up independent households because the job market is so difficult, and because access to housing finance and loan-to-value ratios are so restrictive. However the housing targets, and indeed the whole planning system, is focused on the longer term. We should not alter long-term planning provision for housing or housing targets (whether national, regional or local) in response to short-term economic changes. Any revisions should only be made in response to solid evidence of longer-term changes in household growth and housing demand and need.

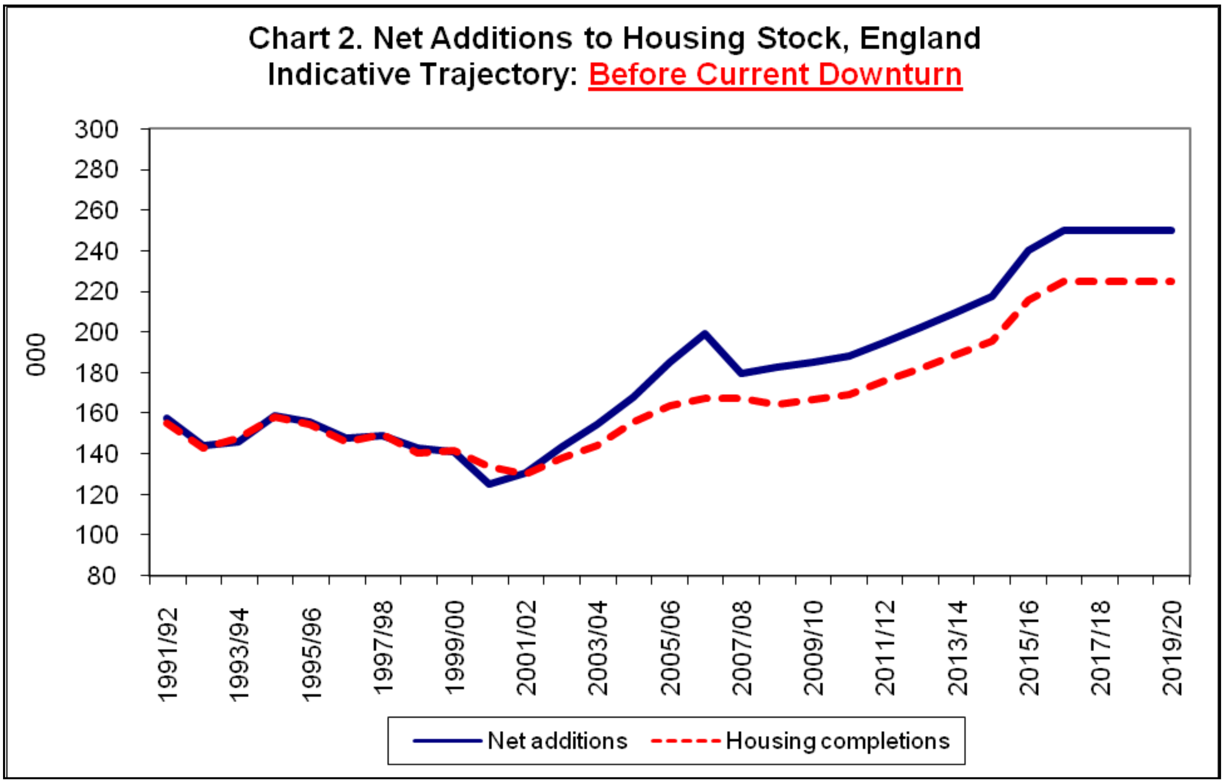
The 2004-based household projections were a key input into the current targets. The more recent 2006-based projections (Chart 1) raised projected household growth for the period 2006-26 from 223,000 per year in the 2004-based projections to 258,000 per year (252,000 per year 2006-31). So the housing targets are, if anything, underestimates of housing need and demand, as the NHPAU acknowledges in the quote above.

3.2 Housing Need and Demand and the Housing Targets

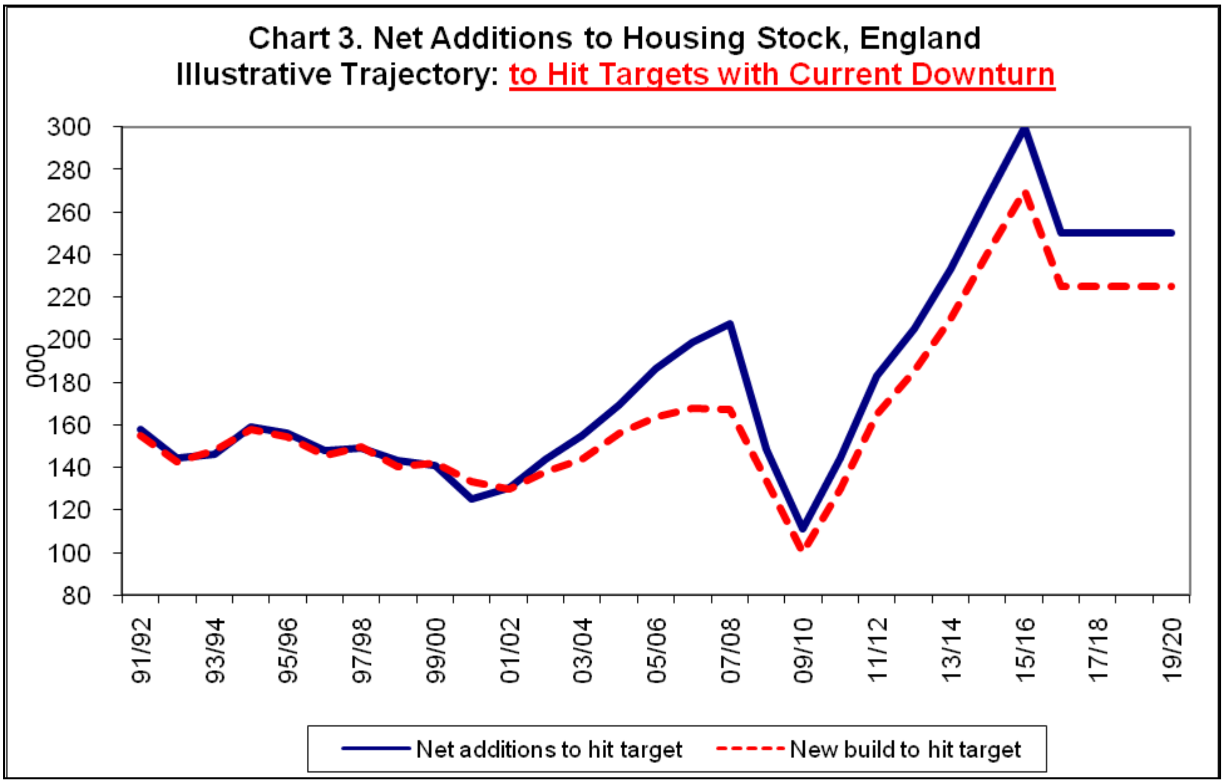
The Government's housing targets for England are for 240,000 net additions to the housing stock[4] in 2016, two million additional homes between 2006 and 2016, and three million between 2006 and 2020. HBF supported the targets at the time they were set, and accepted the underlying evidence on which they were based.

Prior to the housing slump, it was possible to draw a plausible trajectory for housing completions and net additions to achieve all three targets (Chart 2[5]).

[4] Net additions are made up of new housing completions plus net conversions less demolitions. In recent years, new build has accounted for around 90% of net additions.
[5] The house building trajectories in Charts 2, 3 and 4 assume future new build completions represent a constant 90% of net additions.



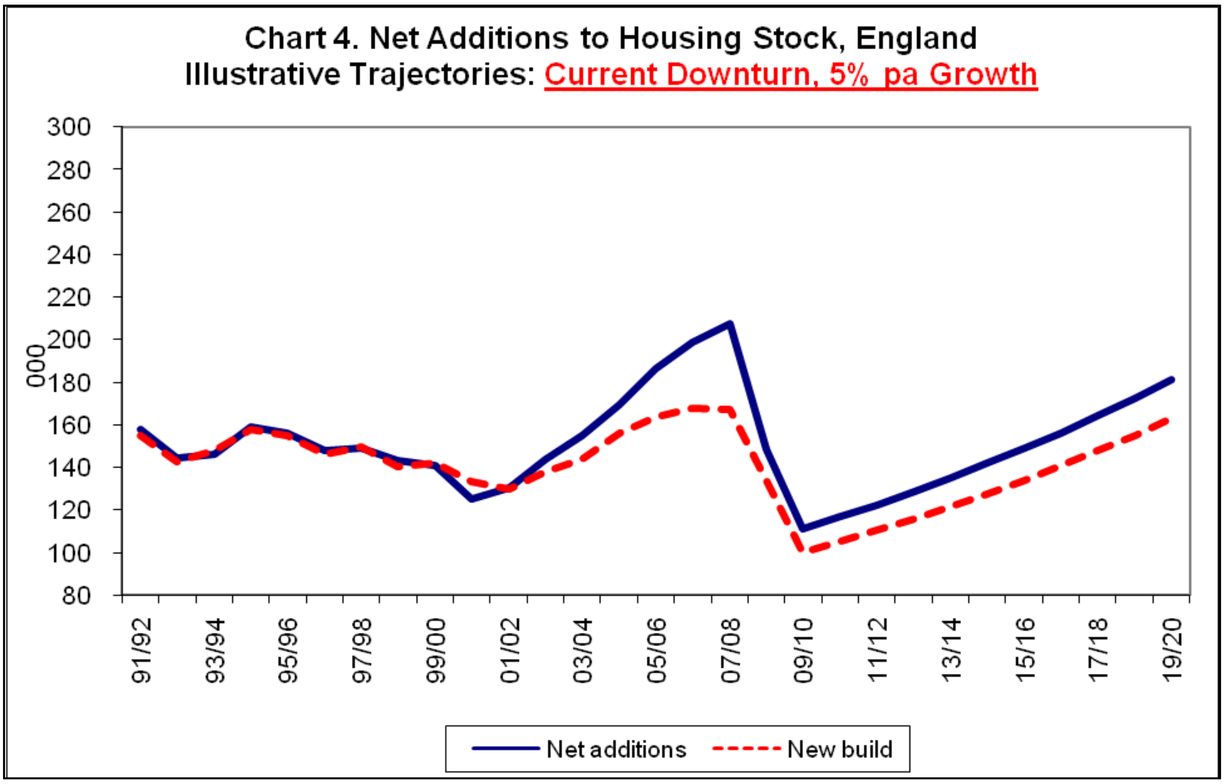
However once the steep drop in house building in 2008 and 2009 is taken into account, the trajectory required to hit the housing targets in the same timescale is implausible (Chart 3). On the reasonable assumption that total housing completions in England drop to around 100,000 in 2009, and assuming the recovery begins in 2010, completions would have to grow by nearly 20% per year up to 2016, and then remain at very high levels for the four years to 2020, to hit the two and three million targets.



Past evidence suggests housing completions growth in excess of 20% per year for six years would be extremely challenging.

During the housing boom of the 1980s, total completions growth averaged 5% per year, with private completions growth averaging 8.6% per year. From 2001-2007, a period of sustained growth in completions, growth averaged just under 5% per year (private completions 4.5% per year). Both periods benefited from buoyant economic conditions, favourable demographic pressures, strong housing markets, and ready availability of development and mortgage finance, with minimal regulatory costs in the 1980s. Few of these favourable background conditions exist today. Since 1950, housing completions growth only ever reached double digits in six years.

If we assumed completions were to grow at an average 5% per year from 2010 onwards, then net additions would reach a cumulative two million by around 2019 or 2020, well beyond the current 2016 target. It would be 2024 or 2025 before the three million target was met (Chart 4).



One objection to the Barker Review analysis is that it ignored demand influences, concentrating exclusively on housing supply. It is suggested that the house price boom up to 2007 was fuelled by the impact of the easy availability of cheap mortgage finance and lax lending terms on housing demand.

Kate Barker's report was indeed concerned with supply influences, not demand, but Barker made it very clear that her focus was the long term:

> "There is growing evidence of a persistent inadequate supply. In the UK the trend rate of real house price growth over the last 30 years has been 2.4 per cent, considerably higher than the European average of 1.1 per cent. Latest evidence suggests that the trend rate of real UK house price growth has increased to 2.7 per cent over the last 20 years. The Review is fundamentally

concerned with the longer-term issues of unresponsive and weak supply, rather than questions surrounding the current house price cycle." [6]

While short-term influences on demand, such as credit availability, lax lending standards or changes in interest rates, will have an impact on the supply/demand imbalance, over the long term these demand influences will have far less impact on house prices and affordability than underlying supply conditions and the two key long-term influences on demand, household growth and growth of living standards.

3.3 Housing Trajectory

All of which suggests that meeting projected housing need and demand, and the Government's targets, will be extremely challenging. This is not because the targets themselves were wrong when they were set, nor that they are any less valid today from a demand perspective. However because the credit crunch and recession have reduced home building to levels no one could have imagined at the time the targets were set, the supply path towards the targets must now begin from a much lower base.

The obvious implication of the very low levels of house building in 2008 and 2009, and the low levels expected over the next few years, is that the large supply/demand imbalance which already existed before the credit crunch will substantially worsen in the short to medium term.

Therefore we need to consider what the industry, Government, government agencies and local authorities must do to achieve completions growth in excess of 5% per year, while at the same time considering how the Government's various housing standards can be met. All parties have a crucial role to play in achieving these objectives.

The industry's attitude towards the likely business and trading environment over the next few years will be a critically important influence on the pace of recovery. If companies judge that the economic and housing market recovery will be long and slow, if they see no relaxation of current and planned policy and regulatory costs, if they believe that local authorities will be unwilling to increase the supply of permissioned land for housing and reluctant to review S106 and other demands, then companies will be very cautious about investing in new land or expanding their business capacity, thereby constraining the rate of growth of housing completions. This in turn will hold back expansion by other participants in the supply chain, most notably manufacturers of building materials and products who often have to make major, long-term investment decisions to expand capacity.

Alternatively, if house builders see hard evidence that central and local government and other public agencies are focused on encouraging increased housing output, reviewing and removing regulatory and policy barriers, working closely with the industry, and taking the actions necessary to allow private developers to grow and meet demand, then they will be much more willing and able to invest in new land and begin to expand capacity. Creating such a virtuous circle will require hard policy choices and trade-offs, and a realistic understanding of the financial realities of housing development.

[6] Kate Barker. *Review of Housing Supply. Delivering Stability: Securing our Future Housing Needs. Final Report – Recommendations*. HM Treasury, March 2004

It is instructive to compare the current pre-recovery situation with that in 1993, at the start of the last recovery. There are a number of important differences which seem likely to influence the strength and duration of the house building recovery.

- **Causes**: The current housing market crisis was initially caused by a sudden contraction of mortgage availability, and subsequently exacerbated by an economic recession; by contrast, the 1989-92 housing slump was triggered by a sudden very sharp rise in interest rates to curb inflation, while the subsequent recession and high interest rates prolonged the housing downturn;

- **Mortgage finance**: the current downturn was caused primarily by the credit crunch, and many experts believe mortgage finance availability and terms will constrain the pace of recovery for some time; whereas the mortgage market was not a significant brake on recovery from the last recession;

- **Severity of Downturn**: the falls in house prices, housing transactions and house building have been much greater and faster than in 1989-92, so that industry capacity has probably been more severely reduced;

- **Affordability**: despite the fall in house prices since 2007, the price of housing in relation to earnings is still relatively high; and while it could be argued housing is much more affordable because interest rates are low, high deposit requirements have created a very high threshold for many buyers; by contrast, the price/earnings ratio in the early years of the 1990s recovery was much more favourable, so that favourable affordability was less dependent on historically low interest rates;

- **Capital**: a legacy of the credit crunch and housing downturn is likely to be that development finance will for some time be more limited and more expensive than in the post-1992 recovery, a constraint which may hit small and medium sized house builders and potential new entrants particularly hard;

- **Regulatory Burden**: the cost impact of regulation and policy on land values was quite modest in 1993, so that recovery quickly translated into a restoration of profit margins and land value; whereas this time round the very substantial current and future costs of policy and regulation will severely constrain development viability and housing output long into the recovery;

- **Housing Mix**: because houses accounted for the majority of housing output in the early 1990s, house builders were able to change their product mix fairly easily and quickly in response to changed market conditions; whereas such a change is more difficult now that apartments make up approaching half of all industry output.

- **Planning Delay and Complexity**: because it now takes so long, and is so expensive, to obtain an implementable planning permission, and because S106 agreements often have to be renegotiated on sites with an existing planning permission, this will slow the speed with which house builders can bring forward viable land in the current recovery compared with the post-1992 period.

3.4 Housing Affordability and Affordable Housing Targets

The fundamental long-term determinant of housing affordability is whether the supply of housing adequately meets housing need and demand. The 2004 Barker Review concluded Britain had suffered from a long-term undersupply of housing (see quote above in 3.2).

More recently the NHPAU has updated Barker's analysis:

> "The story of the past 30 years is of house prices rising by an average of 2.9 per cent a year faster than inflation and increasingly severe boom and bust cycles.
>
> House prices have also been increasing faster than earnings, making housing increasingly unaffordable. Since 1957 real house prices have risen by 2.7 per cent per year, while real household disposable income growth has averaged 2.5 per cent per year. The disparity has become increasingly stark over the last ten years with the price of a lower quartile house rising from under 4 times lower quartile earnings in 1997 to over 7 times lower quartile earnings in 2007".[7]

Therefore the long-term solution to housing affordability is to ensure there are enough homes, which means that the housing stock must expand adequately.

In addition to its net additions housing targets, the Government also has targets for Affordable Housing delivery. Affordable Housing is narrowly defined in Planning Policy Statement 3 (PPS3). Essentially it is housing which is sold or rented at below market rates, using subsidy from public funds and/or private land value (through S106 planning obligations agreements).

The Government's Affordable Housing targets are not comparable with the overall net additions targets because they refer to all forms of Affordable Housing, including new build, purchases of second-hand stock by RSLs[8], subsidies given to social housing tenants to buy a home in the open market, etc.

However there is clearly a link, via affordability, between overall housing supply and the need for Affordable Housing: the bigger the long-term mismatch between housing supply and demand/need, the worse will be the impact on house prices and housing affordability, and therefore the greater will be the need for subsidised Affordable Housing (i.e. housing for those who cannot afford market prices or rents).

So the same solution applies both to alleviating housing affordability, and to reducing the need for subsidised Affordable Housing: make sure the total supply of housing is adequate to meet demand and need.

Of course there will always be a need for subsidised housing for some households who cannot meet their own needs in the housing market, whatever the overall affordability of housing. However there is also a large 'intermediate' group who would be able to meet their own needs in the owner-occupied or rented markets without subsidy if affordability was at reasonable levels, but who are excluded when

---

[7] NHPAU *More homes for more people: building the right homes in the right places*. July 2009
[8] RSL: Registered Social Landlord, such as a housing association.

affordability is very stretched. The worse the level of affordability, the larger this group will become. They are caught between a rock – too well off to qualify for subsidised social rented housing – and a hard place – not well off enough to be able to buy or rent in the open market.

It is worth noting that Affordable Housing provided through S106 agreements on private housing sites does nothing to improve affordability because it does not produce any additional dwellings. It simply represents a tenure change in which homes that would have been sold into the open market if there had not been a S106 requirement are instead sold to an RSL to end up as social rented, shared ownership or intermediate rented housing.

The narrow definition of Affordable Housing in PPS3, however well intentioned, has been counterproductive. Because it has led to a narrow focus on subsidised, sub-market housing, it has made it more difficult for home builders to provide affordable market housing or privately funded financial packages[9].

3.5 The Scale and Consequences of Housing Undersupply

The Barker Review, carried out in 2003 and early 2004, was the most comprehensive examination of housing supply since the 1977 Housing Policy Green Paper. Barker concluded very firmly that England suffers from a serious, long-term undersupply of housing:

> "I do not believe that continuing at the current rate of housebuilding is a realistic option, unless we are prepared to accept increasing problems of homelessness, affordability and social division, decline in standards of public service delivery and increasing costs of doing business in the UK – hampering our economic success."

The Treasury's comprehensive euro assessment, published in June 2003, had already reached a similar conclusion. The study found:

> "high house price growth and volatility, reflecting to a significant extent the low supply response of house building in the UK".[10]

One very striking feature of housing in the 1990s was that between the end of the recession (1992) and 2001, private housing completions barely changed. Yet we would have expected sustained economic growth, rising living standards and strong demographic pressures to have pushed up private housing activity. This puzzle lay at the heart of the Barker Review.

A number of indicators demonstrate the scale of housing undersupply:

- **Supply/Demand Gap**: between 2000 and 2008, household growth in England averaged 203,000 per year. Over this same period, the housing stock expanded by just 166,000 dwellings per year, a shortfall of nearly 40,000 homes per year just to keep pace with household growth. The most recent estimates suggest England will need somewhere between 237,800 and

[9] Home Builders Federation *Expanding Choice: increasing the supply of affordable housing. A report of the HBF Affordable Housing Policy Group*. July 2007
[10] HM Treasury *UK Membership of the Single Currency; and assessment of the five economic tests*. 2003

290,500 additional homes per year over the period 2008-31[11]. In 2007-08, at the end of a long housing boom and before the credit crunch began to have a significant impact on house building levels, the housing stock in England expanded by 207,500. This figure will have dropped sharply in response to the recession.

- **Real House Price Inflation**: the Barker Review[12] in 2004 produced clear evidence that real (i.e. inflation-adjusted) house prices in Britain had, over the long term, risen more rapidly than in many other developed countries, a clear indication of a long-term imbalance between housing supply and demand/need (see Barker quote section 3.2). More recent estimates by the NHPAU show that over the last 30 years house prices have risen by an average of 2.9% a year faster than inflation, with increasingly severe boom and bust cycles[13]. Since 1957, the NHPAU estimates that real house prices have risen by 2.7% per year, whereas real household disposable income growth has averaged 2.5% per year.

- **Vacancies and Demolitions**: Britain's housing vacancy rate is low by international standards[14]. The current housing demolition rate, at around 20,000 per year in England, means it will be nearly 1,100 years before today's new homes reach their turn for demolition[15]. Both are signs of housing stress.

- **Housing Stock Growth**: new homes make a very small contribution to the housing stock each year, and levels of new home building in relation to the population size are exceptionally low by international standards. At the peak of the market in 2006-07 and 2007-08, new homes added 0.75% annually to the total housing stock. The number of new homes built per 1,000 population is among the lowest in Europe[16].

Housing undersupply has many adverse social and economic consequences:

- **Homelessness**: in March 2009, there were 53,400 household accepted as homeless in England, with another 64,000 in temporary accommodation. We might view these two statistics as the most acute manifestations of housing stress.

- **Waiting Lists**: local authority waiting lists, at 1.77 million households in April 2008, had risen 62% since 2002 and 73% over the last 10 years. The National Housing Federation (NHF) has warned that the number of people on waiting lists will rise to five million by 2010.

- **Overcrowding**: there are over one million children in overcrowded housing in England, according to Shelter[17], based on figures from the official Survey of

[11] NHPAU *More homes for more people: advice to Ministers on housing levels to be considered in regional plans*. July 2009
[12] Kate Barker. *Review of Housing Supply. Delivering Stability: Securing our Future Housing Needs. Final Report – Recommendations*. HM Treasury, March 2004
[13] NHPAU *More homes for more people: building the right homes in the right places*. July 2009
[14] Office of the Deputy Prime Minister *Affordability Targets: Implications for Housing Supply*. December 2005 (page 48); and *Housing Statistics in the European Union, 2004*
[15] There were 20,500 demolitions in England in 2007-08, out of a housing stock of just over two million dwellings, according to CLG statistics.
[16] *Housing Statistics in the European Union, 2004*
[17] Shelter press release, 29 July 2009

English Housing. The 2007-08 Survey revealed a total of 565,000 overcrowded households in England (averaged over the three years 2005-06 to 2007-08), 2.7% of all households. In addition, one in 16 residences included extra families or individuals, according to NHPAU estimates[18].

- **Impact on First-time Buyers**: the number of loans to first-time buyers in the first quarter of 2009 fell to the lowest level since records began in the early 1970s, according to statistics from the Council of Mortgage Lenders (CML). The NHPAU has estimated that of those 18-34 years olds who do not currently own their own home, almost nine out of ten cannot afford to buy an average priced first-time buyer property with their current income, meaning that well over six million people will not be able to get on the home ownership ladder[19]. Two thirds (67%) of adults think the biggest consequence of the high cost of housing is on young people and first-time buyers who cannot get on the housing ladder and are forced to continue living with their parents.

- CML research shows that while the average (mean and median) age of all first-time buyers has not changed significantly since 2005, the average age of first-time buyers *excluding those getting financial help*, which was fairly stable at around 33 up until late 2007 when the credit crunch began, has now risen to around 37[20]. The median first-time buyer deposit had risen from the range £11-13,000 from 2004 to mid 2007 to nearly £32,000 by mid 2009.

- **Living at Home**: there has been a sharp rise during the last decade in the number of younger people living at home with their parents, according to the latest *Social Trends*, with housing affordability a key reason:

> "In the second quarter of 2008, 29 per cent of 20 to 34 year-old-men and 18 per cent of women of the same age lived with their parents."
>
> "Since 2001, the number of 20 to 34-year-olds living at the parental home has increased by nearly 300,000. In 2001, the proportion of young adults living at home stood at 27 per cent of 20 to 34-year-old men and 15 per cent of women in the same age group."[21]

- **Distributional Consequences**: high real house price inflation, as a consequence of housing undersupply, has very uneven distributional consequences. Those who do not own a home, whether young people who have not yet formed an independent household, or households in the rented sectors, fall further and further behind home owners in terms of their household wealth. They find it increasingly difficult to access home ownership as prices rise more rapidly than incomes.

- **Financial Consequences**: high house prices tend to lead to higher levels of household debt in relation to income, especially for young households, which is financially burdensome for these households and increases their vulnerability to default in the event of unemployment, financial problems or household breakdown. Many young people now have to rely on parents or

[18] NHPAU *More homes for more people: building the right homes in the right places*. July 2009
[19] NHPAU *Public Attitudes to Housing 2009*. July 2009
[20] CML News and Views, No.15, 4 August 2009 *First-time Buyers – are they really getting older?*
[21] Office for National Statistics *Nearly a third of young men live with their parents*. News Release, 15 April 2009

grandparents to raise the deposit for a new home, so that home ownership becomes dependent on parental wealth, thereby excluding young people whose parents are less well off. CML research indicates that around 80% of first-time buyers under 30 are getting financial help to raise funds for a deposit.

- **Labour Market Consequences**: housing undersupply also has adverse labour market consequences. Households find it very difficult to move from low to high priced areas, so that labour mobility is impeded and unemployment differences tend to be perpetuated. In addition, employers have to pay more to attract employees in high priced areas, which has implications for the competitiveness of businesses in these areas. Public services such as education, health and social services, which are required in every community, find it difficult to attract employees in medium and lower income occupations in high priced areas, as do lower-pay private sector businesses.

3.6 Housing Providers

Achieving the Government's housing targets will be largely dependent on private house building. This in turn will require a favourable business and regulatory environment to encourage investment, expansion and innovation.

Owner occupation in Great Britain (England) in 2007 was 69% (70%), with 12% (13%) privately renting, 10% (9%) public sector housing, and 9% (8%) RSL housing.

In the eight years from 2000 to 2008, private housing completions[22] in England accounted for between 87% and 91% of total completions. The remaining 9-13% of completions were social rented dwellings, almost all provided by RSLs, with a tiny contribution from local authorities.

Although the statistics are incomplete, HBF estimates that of total housing completions annually in England, approximately two thirds are sales to owner occupiers or private landlords, around 9% are self build for owner occupiers, approximately 11% are intermediate sale (e.g. shared ownership) or rent, and the remaining 14% are social rented dwellings.

Periodic opinion surveys by the CML, going back to the mid 1970s, show very high levels of aspiration to home ownership. For example, the most recent (2007) survey found 84% of adults would prefer to be an owner occupier in 10 years time, and 78% said home ownership was their preferred tenure in two years time. The 10-year aspiration has shown only small variations since the early 1980s.

Taking all this evidence together, it is clear that a large majority of new housing provision needs to be built for sale to owner occupiers or private landlords. This in turn suggests house building needs to be predominantly carried out by organisations building homes for sale in the open market.

(The types of providers and their business models are discussed in Section 4.7.)

[22] Private enterprise housing in the official statistics is defined to include homes sold to owner occupiers or private landlords, RSL shared ownership sales and intermediate rented dwellings, and self-build units.

3.7 Housing Qualify and Standards

House builders achieve high levels of customer satisfaction. Building standards imposed by the public sector which go beyond those required by home buyers – and which home buyers will therefore not pay for – add cost to development which has to be funded out of land values, and so risk reducing housing supply.

The Government requires not just substantially higher housing numbers, but also high standards of build quality and customer satisfaction, world-beating sustainability standards for new homes and a range of other standards.

The industry achieves high levels of customer satisfaction. According to HBF's annual new home buyer survey, 77% of new home buyers in 2007-08 were satisfied with the quality of their home (13% were dissatisfied, and 9% neither satisfied nor dissatisfied). A survey by CABE in 2006 found 91% of new home buyers were satisfied (49% very satisfied) with their home (5% dissatisfied)[23]. According to an OFT survey of new home buyers in 2008, 80% would be very or fairly likely to buy a new home again, with 70% saying they would be likely to buy from the same home builder again[24].

To help improve customer satisfaction even further, industry trade bodies and two warranty providers have set up a Code of Conduct which will be fully implemented in April 2010. In addition, individual companies, which are ultimately responsible for build quality and customer service, are striving to improve their levels of customer satisfaction. A number of large home builders have shown clear improvements in customer satisfaction in the four years of the HBF survey.

HBF and individual home builders have worked closely with Government ministers and officials ever since the zero-carbon target was first announced. This work will continue as we approach the various milestones towards zero carbon in 2016, beginning with Code 3 energy requirements in 2010 and Code 4 energy in 2013.

The zero-carbon objective, already a major challenge before the recession, is now an even more formidable task. The industry and Government will need to make sure this challenge is not met at the expense of housing numbers (see 4.4 below, Viability and Regulatory Costs, and Appendix).

There is currently a lively debate about housing space standards. Parker Morris space standards for public housing, introduced in the late 1960s, were abolished in 1980 largely because local authorities could not afford the cost of such housing, given severe constraints on public spending at the time. Today, Britain faces an unparalleled public sector deficit, so that draconian controls over public spending seem unavoidable from 2011 onwards. Therefore there must be a question mark over whether this is a sensible time to be talking about imposing minimum space standards.

It is important too to understand why dwellings in this country are so small and the consequences of imposing minimum space standards.

[23] CABE *A Sense of Place; what residents think of their new homes*. 2007
[24] Office of Fair Trading (OFT) *New homebuild consumer survey*. June 2008

European comparisons indicate the average size of homes in the existing housing stock of England is exceptionally small[25], and homes are significantly smaller than those in North America and Australasia.

The primary reason is our highly restrictive planning system which severely rations the supply of permissioned land, and has resulted in an undersupply of housing extending back two decades or more (see 3.1 above).

It is sometimes argued that this is necessary because Britain is a relatively small country with a large population. However our very tight restrictions on land supply are the result of political choices. There is no shortage of land, only a shortage of land with permission to build (see section 4.3).

Britain also has an exceptionally high level of urbanisation. UN statistics show 89.9% of the UK population lives in urban areas, the eight highest rate in the world[26]. In addition, a very high proportion of new housing is built on already developed land (79% in 2008 including conversions), most of which is in urban areas.

The restricted supply of new land for housing, especially since 2000, and the heavy concentration of new housing on brownfield land in our already dense urban areas, have been the result of policy decisions by central and local government.

These choices have major consequences. Over the longer term, it means house prices rise well ahead of inflation, so that we face persistent problems of poor housing affordability. Shortages of housing and residential land, policies to concentrate new housing on brownfield urban land, and the resulting high price of housing, mean house builders have to build relatively small dwellings if they are to keep the price of new homes within the affordability range of a broad market and achieve reasonable sales volumes.

If the state imposes minimum space standards, house builders will be able to build to the required sizes. However the result will be fewer new homes (unless there is a compensating increase in land supply), and those that are built will be more expensive, thereby aggravating the affordability crisis. The new homes in each house type which fall below the minimum space standard will no longer be built, so that buyers who could have afforded these homes will no longer be able to find a suitable new home on the market at an affordable price.

As with a number of other major housing problems in Britain, the only solution to relatively small dwelling sizes is for the supply of permissioned land to allow house builders to meet housing demand and need. A sustained, long-term increase in housing provision would gradually improve affordability and allow larger dwellings to be supplied at affordable prices for a broad market.

[25] *Housing Statistics in the European Union, 2004*
[26] United Nations *World Urbanization Prospects. The 2007 Revision*. February 2008. The UK is eight among major countries after excluding a number of tiny islands and city states.

4. MAXIMISING HOUSING DELIVERY IN THE RECOVERY

While the home building industry's short-term focus is on coping with today's very challenging market conditions, the longer-term concern for central and local government and for the home building industry must be how to raise the recovery growth trajectory for housing completions above 5% per year. The steeper the recovery, the faster we will meet the country's housing needs, and the less the social and economic damage caused by housing undersupply.

Given the extremely tight public spending and borrowing conditions expected over the medium term, it seems highly unlikely the public sector will be able to fund a large-scale social housing programme, either directly or through housing associations. Therefore most of the increase in house building will have to come from the private sector, a conclusion consistent with most people's desire to own their own home (see 3.6 above). Given concerns about the impact of policy and regulation on viability, it will also be necessary to consider the role that new or alternative finance mechanisms might play in helping to meet the Government's housing and housing-related objectives.

To maximise the rate of growth of private house building, a number of major obstacles will have to be addressed, and private developers will have to be encouraged to invest and grow. We also need to consider how to assist first-time buyers and other lower-income households to find adequate housing, whether by assisting them to access owner occupation or by broadening the supply of private rented housing. The remainder of this paper addresses these issues.

Most of our recommendations relate to public sector policy, rather than actions the industry can take on its own. This is hardly surprising, given that the supply of housing is so heavily controlled by central and local government policies and regulations: the state, through the planning system, tightly controls the location and quantity of permissioned residential development land; it has significant control over the industry's products (e.g. through Building Regulations, national and local policies on densities, mix and design, or the zero-carbon target), and the state makes very sizeable demands on land value to fund a range of housing and housing-related policy objectives. In addition, the public sector owns somewhere between a quarter and a third of all potential residential land (see section 4.7). The Homes and Communities Agency (HCA), which has responsibility for a large proportion of the land owned by central government, imposes a range of standards (e.g. space, design, sustainability) on the homes built on land it supplies to home builders.

If the state imposes such extensive controls over almost every aspect of housing delivery, then it must accept a heavy responsibility for lifting the main obstacles to delivery.

4.1 Economic Pre-conditions for a Home Building Recovery

The pre-conditions for a sustained house building recovery are a restoration of mortgage funding, an end to the recession and an end to house price falls. Until these conditions are achieved, effective housing demand will remain weak, and the recovery in home building will be constrained.

A restoration of mortgage funding is not expected to bring a return to 2007 mortgage terms, but it should begin to allow some modest relaxation of loan-to-value ratios and other forms of mortgage rationing, so that the pool of potential home buyers able to buy can begin to expand. The outcome of the Turner Review will be permanently tighter regulation of mortgage lenders, and possibly of mortgage products, although it is very important future regulation does not unduly constrain new home sales and house building.

However even when mortgage lending does eventually begin to increase and the economy stabilises, no one can be certain whether the housing market slump will be followed by a sharp rebound, or whether the market will struggle to recover for several years, as it did between 1993 and 1996 following the 1988-92 crash. Many commentators believe we face a long, slow recovery, and few expect a sudden restoration of mortgage availability.

In view of the scale of today's economic uncertainties, it would seem sensible to assume house building over the next few years will operate within a subdued housing market, with only a slow recovery in transactions, less favourable mortgage terms than in the years up to 2007, and restricted mortgage availability for some time. Such an environment would constrain house builders' ability to lift completions in the absence of other measures.

It is especially difficult to predict the path of house prices. Some commentators expect further substantial falls in the second half of 2009 and into 2010, and there is great uncertainty about the rate at which prices will increase once the recovery takes hold. The acute supply/demand imbalance suggests prices could rise rapidly once the market stabilises. However, economic and fiscal conditions, restricted mortgage availability and terms, and tighter mortgage regulation may constrain house price growth for some time.

The future path of house prices will be very important for house builders' profitability and land values, and therefore for land purchase and house building activity. It will also be critical to many Government policy and regulatory demands which were to have been funded out of residential land value (see 4.4 below, Viability and Regulatory Costs).

It may be tempting to assume house building viability and funding for public policy demands will be quickly solved by a sharp rise in house prices. Not only would this be a risky assumption, but even more fundamentally the success of central and local government policies and regulations should not require a return of rampant house price inflation.

4.2 Permissioned Land Supply and Planning

Without permissioned land, house builders cannot legally build new homes. Local planning authorities are responsible for local development plans, and they alone have the legal power to grant residential planning permission. Therefore local authorities have a critical enabling role in ensuring there is an adequate supply of permissioned land for housing.

The number of residential planning applications has fallen sharply in the recession[27]. In addition, many house builders have slowed down or ceased progressing large, long-term strategic sites.

In the initial stages of the recovery, house builders will be able to draw on their existing land banks. However as the recovery gathers pace, the industry will have to start rebuilding the supply of permissioned land. Given the time taken to obtain an implementable planning permission, house builders will have to start this process early in the recovery. In addition, the slowdown in work progressing large, complex strategic sites during the recession is likely to leave a gap in future land stocks, given the very long periods required to obtain an implementable permission for these sites.

The development plan system controls the amount of residential land, and so has a major influence over the number of new homes delivered. Therefore if local planning authorities do not have robust plans in place, this will have an adverse impact on the supply of land for housing.

The Government's revised local planning target is that 80% of all local planning authority Development Plan Documents (DPDs) should be adopted by March 2011. As at April 2009, only 10% of the necessary DPDs had been adopted[28]. According to current local authority estimates, CLG says "a significant number are due to be adopted over the next two years although we are aware of slippage and achieving the 80 per cent target will be very challenging." (As it took local authorities five years to adopt just 10% of DPDs, it will clearly be a major challenge to lift this to 80% in less than two years.) Fewer than 15% of local authorities have an adopted, sound Core Strategy[29], a key document in the new development plan system.

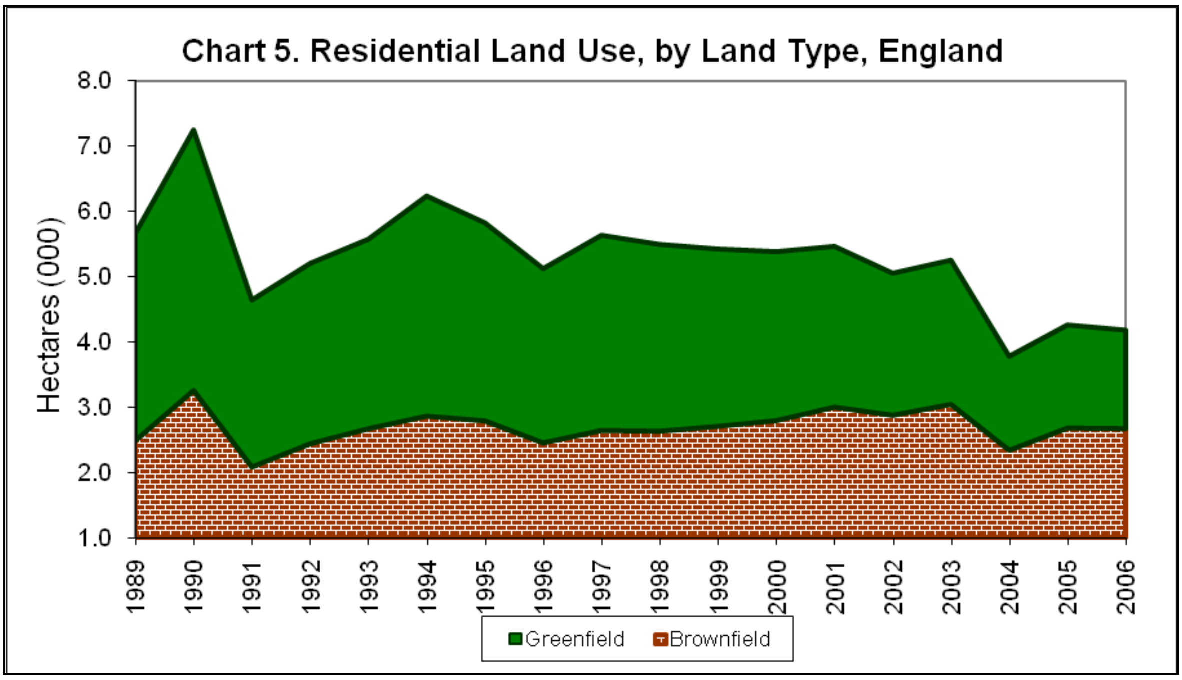
The Government's original intention was that all planning authorities would have a Local Development Framework (LDF) in place within three years of the 2004 Act[30]. As plan preparation is so far behind, it is hardly surprising there is a shortage of permissioned residential land.

Is worth noting there was a similar failure in the 1990s. A Conservative Government introduced the plan-led system in 1991, requiring every local authority to have a plan in place by 1995. In 2000, Labour Housing Minister Nick Raynsford revealed that most local planning authorities either had no adopted plan, or their plan was out of date or nearly expired.

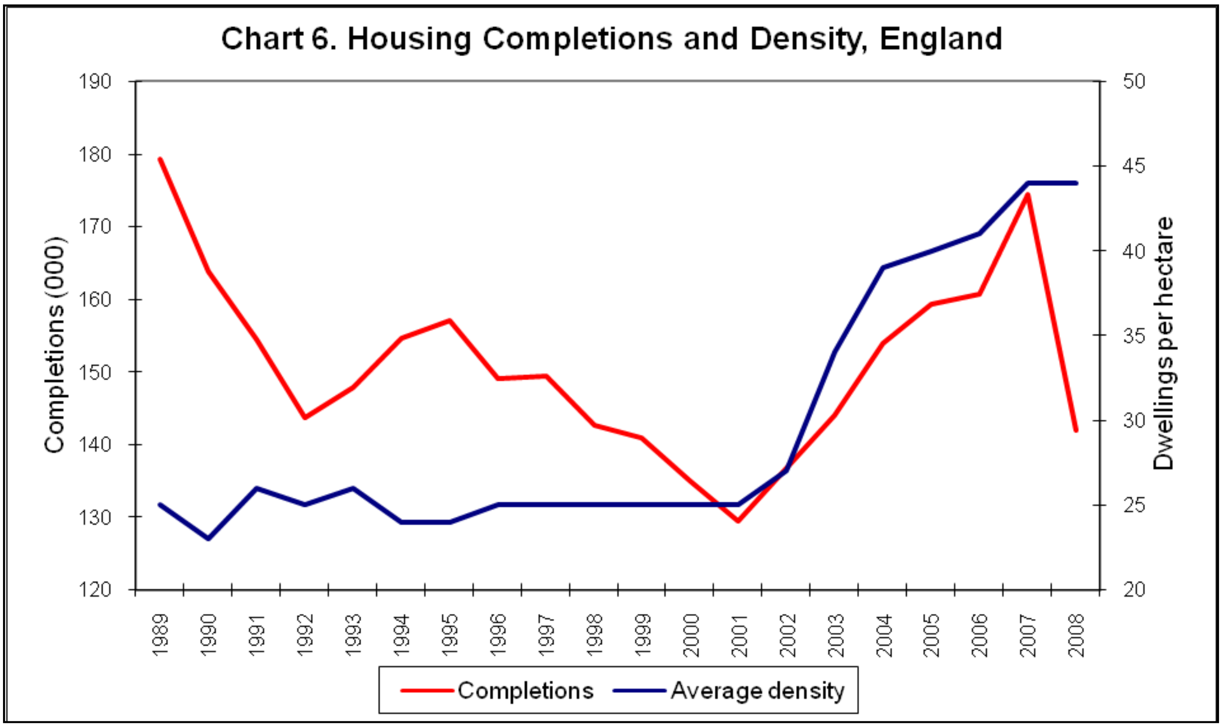
The area of land developed annually for housing has been falling since the mid 1990s (Chart 5). Between 2000 and 2006 (the latest available statistics), the total area of land used annually for housing fell 23%, with a 5% fall in annual brownfield land and a 42% fall in annual greenfield land[31].

---

[27] In the first quarter of 2009, quarterly 'major' (10+ units) residential planning decisions fell to 1,300, less than half the numbers recorded between the second half of 2004 and 2006.
[28] Communities and Local Government (CLG) *Annual Report 2009*
[29] Homes and Communities Agency (HCA) *HCA Investment and Planning Obligations: Responding to the Downturn*. July 2009
[30] CLG *Planning Policy Statement (PPS) 12. Creating strong safe and prosperous communities through Local Spatial Planning*. 2008
[31] Land use statistics are taken from Communities and Local Government (CLG) *Land Use Change Statistics (England) 2008 – provisional estimates (July 2009)*.



The only reason housing completions rose between their historic low in 2001 and 2007 was a steep rise in average densities (Chart 6). Without this rise, housing completions would have fallen even further.



Despite major changes to the development plan system in 2004, it has yet to show any evidence of a significant increase in the supply of permissioned land. Whether this situation will improve in the upswing is difficult to judge.

It is very important that regional planning bodies and local planning authorities do not attempt to use the recession and the fall in house building as an excuse to cut back on land supply and housing provision. Planning is about long-term provision. Housing numbers in regional and local plans should not be revised in response to short-term economic influences, however severe, until we have solid evidence that these influences have had a long-term impact on housing demand and need. The requirement for each local authority to have a five-year supply of developable land is just as important today as it was two years ago, although it is clearly more difficult for local authorities to assess the viability of land at present.

The key to higher housing output is not just more land, but more sales outlets. It is almost a law of residential development that there is a limit to the number of sales that can be achieved in a year from any one sales outlet. The long-term average is approximately 35 sales per outlet per year. Therefore, all else being equal, a 50% increase in sales requires not simply a 50% increase in land supply, but a 50% increase in the number of sales outlets. Although it is common on large sites for house builders to open up more than one sales office, or to sell parts of the site to other developers, when local planning authorities concentrate development by releasing a few large sites, this does tend to limit the industry's sales capacity. A more effective approach is to release many smaller sites, thus increasing the number of sales outlets. It would be much more effective in sales and output terms to encourage a variety of residential land releases in every city, town and village, rather than to focus a large proportion of development in a limited number of major growth areas.

4.3 Housing Mix, Density and Land Requirements

If house builders are to expand output, they must be allowed to supply products which meet local demand. This will require flexibility and realism from local planning authorities. The more central government and local authorities try to impose densities and housing mixes that diverge from house builders' assessments of local demand, the more they will constrain the recovery in house building.

Average densities in England have risen dramatically, from 25 dwellings per hectare (dph) in 2000 to a provisional 44 dph by 2008[32]. Average densities had been close to 25 dph for decades, so this 76% increase represents a historic change. This was made possible almost entirely by a switch out of detached houses into apartments[33].

It is now clear that apartment building in many locations was excessive, while the supply of family housing has been inadequate.

The overall mix and average densities that evolved in the boom, in response to both supply and demand influences, are unlikely to be appropriate for the recovery. House builders are going to be far more focussed on devising product mixes and densities which accurately meet local demand. This in turn will require greater flexibility from local planning authorities.

Academic research for HBF[34] into the relationship between household sizes and ages and housing space found that future household growth points to the need for many more larger homes, with fewer small dwellings, thus giving demographic support to frequent claims that we need more family homes and fewer apartments.

---

[32] CLG *Land Use Change Statistics (England) 2008 – provisional estimates (July 2009)*.
[33] According to NHBC, 50% of private housing registrations were detached houses in 2000 and 21% were apartments. In the 12 months to the first quarter of 2009, only 21% of private registrations were detached houses, whereas 43% were apartments. Over this period, the semi and terraced house shares did not change significantly.
[34] *Room to Move? Household Formation, Tenure and Housing Consumption*. Professor Dave King. HBF, January 2005

The is primarily a consequence of the ageing population, as relatively few older households trade down and release larger family homes for younger households trading up in the early stages of their housing careers.

If average densities fall over the next few years, as seems inevitable, then more land will be required to achieve any given level of housing output than would have been required at recent high densities. For example, for every 1,000 new homes, 22 hectares of permissioned land are required at 44 dph, but 33 hectares at 30 dph. So we need to see an increase in permissioned land supply to meet the growth in need and demand, and a further increase to compensate for the expected fall in average densities.

There is no shortage of land in England. Urban areas account for somewhere between 8.3% and 13.5% of the total land area[35]. There is however a severe shortage of permissioned land, land on which house builders can legally build.

Between 2000 and 2006, an average of 4,760 hectares of land per year was used for new housing, with an average 42% (1,990 hectares) of this greenfield, or previously undeveloped land. This new land represents 0.015% of England's land area per year. At this rate, it would take 67 years for housing to cover an additional 1% of England's land area. Claims that house building requires "concreting over the countryside" are absurd.

Home buyers are the best judges of their own interests. House builders, because they need to earn a profit by building homes that people want to buy, and can afford to buy, are much more likely to be attuned to assessing the right products to meet local demand on a particular site than local authority officials.

4.4 Viability and Policy and Regulatory Costs

Existing assumptions that residential land values will finance current and planned future housing policy, regulation and taxation are incompatible with achieving high levels of house building. Difficult policy choices and trade-offs are required.

The cumulative cost impact of taxation, policy and regulation on residential development, imposed by central and local government and other public agencies, will be one of the biggest brakes on the house building recovery once mortgage availability has been restored. We are talking here about taxation, policies and regulations which add significantly to development costs, but which do not generate a compensating increase in sales revenue, so that the additional cost ultimately has to come out of land value.

Even by mid 2007, before the credit crunch, policy and regulatory demands were having such a heavy impact on land values that many sites were at the margins of viability[36]. However the escalating additional costs from measures planned for the next eight years (zero carbon, infrastructure funding through S106 agreements or the

---

[35] *The Barker Review of Land Use Planning* reviewed various estimates of the urban area which ranged from 8.3% to 13.5%.

[36] Viability has two key components. The developer must earn a competitive return for his investment. And the development must generate sufficient land value to persuade the land owner to sell his land for residential development. This latter requirement is not just a case of offering the land owner an acceptable value, but the residential land value must also exceed the land's current use value and any alternative use value.

proposed Community Infrastructure Levy (CIL), revisions to Building Regulations, Lifetime Homes), on top of existing demands, and set against the sharp fall in land values since mid 2007, mean that few residential development sites are currently viable. If we assume slow economic and housing market recoveries and continuing mortgage constraints well into the future, it will be a long time before land values recover to levels sufficient to fund all these policy and regulatory demands.

The cumulative impact of policy and regulation has the heaviest impact on large strategic greenfield sites, which have major infrastructure and other costs, regeneration schemes, which have very heavy development costs and limited residual land value, and urban brownfield sites in the Midlands and north where house prices (and therefore land values) are relatively low.

The most costly current and future policies, and therefore those with the biggest impact on viability, are local authority demands to fund community infrastructure[37] and Affordable Housing, and the cost of achieving the Government's energy efficiency zero-carbon standards in 2010, 2013 and 2016.

Regeneration schemes have been particularly badly affected because their heavy development costs leave a relatively low residual land value, even before allowing for the cost of policy and regulation. Many are now deeply 'under water' – i.e. the total development costs far exceed the anticipated gross sales value from the proposed development, so that the land value is negative.

We should stress however that we are not questioning the desirability of individual items on the long list of central and local government policies and regulations. Our concern is with how they are to be funded and their impact on viability. Many were imposed in the boom years, or plans to impose them were drawn up in the boom years, on the assumption that they could be funded out of residential land value. Land values had been lifted for many years by both rising house prices and sharply higher densities, so that these policy demands seemed affordable.

Now that this land-value pool is no longer available to fund all these aspirations, following sharp falls in house and land prices since 2007, and with average densities likely to fall over the next few years, and faced with escalating policy and regulatory costs over the next seven years, a recovery in house building will need the cumulative cost impact to be drastically reduced. This will require a combination of finding alternative sources of funding or grants for some demands, delaying the introduction of some, scaling back certain demands, and redesigning some policies to achieve their objectives in a different way. For example, alternative sources of funding must be found for social house building or social infrastructure. And while house builders accept the need to make the fabric of homes as energy efficient as possible, subject to additional expenditure being cost effective, they are anxious to avoid becoming on and off-site energy suppliers, a task that should be undertaken by specialist energy providers.

One important aspect of these trade offs will be the degree to which individual policies or regulations can be varied or negotiated at local level. The stages to zero-carbon will be achieved through revisions to Part L of the Building Regulations. National Building Regulations are mandatory on all house building, so local

[37] At present, community infrastructure demands are levied via S106 planning obligations, whether individually negotiated or through local tariffs. In future, the Community Infrastructure Levy (CIL) will be used to fund such demands, so that S106 demands will have to be scaled back.

authorities cannot alter their cost impact on individual local developments. When the CIL is introduced, the Government's intention is that it will not be negotiable for individual sites. Therefore it will be critically important that each local CIL is set at a level which allows most local housing developments to remain viable. Given that zero carbon and CIL will be non-negotiable at the individual site level, demands for Affordable Housing, which are locally negotiable, will inevitably have to take much of the strain, especially if a local authority's CIL is set at a high level.

HBF warmly welcomed the Government's announcement in the Budget that it will produce a report for the *Pre-Budget Report* which will "identify, working with industry and other partners, the best regulatory and policy framework to support the Government's long-term housing objectives". We hope this report will be based on a realistic and comprehensive assessment of the whole range of policies, regulations and taxes imposed by central and local government and other agencies, and that there will be full recognition of the choices and trade-offs that will have to be made if the housing targets are to be achievable. For example, if the costly zero-carbon objective for 2016 remains in place, the report should make clear that other policy demands, most notably Affordable Housing, will have to be sacrificed.

A full list of policies, regulations and taxes with an impact on viability, organised into categories, is shown at Appendix 1, with recommendations for each category. To help promote a significant increase in housing numbers in the recovery, while also achieving at least some of the Government's priority policy objectives, we make the following recommendations:

- House builders fully accept that the costs of **direct site mitigation** should be paid for out of site land value; but unless alternative sources of funding are found for the many additional regulatory and policy costs, there will be insufficient land value available to fund site mitigation, so that fewer homes will be built;

- If central and local government want new homes to meet **world-beating sustainability standards**, these very significant costs will require alternative sources of funding if they are not to be at the expense of many other policy objectives (most notably the big-cost items Affordable Housing and community infrastructure provision). House builders should be concentrating on efficiently building energy-efficient homes to meet consumer demand, not learning how to become on and off-site energy providers. Local authority demands for forms of on-site energy which are not cost effective are in effect squandering scarce land value;

- Site-specific **design demands** above and beyond the requirements of home buyers should be curbed, and local authorities should be fully aware of the impact of such demands on costs, building efficiency and land and housing supply;

- The public sector should pay for **community infrastructure** (e.g. education, health, etc), as it always did out of general taxation before S106 agreements became widespread;

- If policy and regulatory demands are not drastically scaled back, **Affordable Housing subsidy** will not be available from land value, so the state will have to find alternative sources of funding for Affordable Housing;

- The Treasury must include all forms of **residential development taxation** in the report on policy and regulation for the *Pre-Budget Report*, and where possible moderate its demands;

- Demands by public agencies for substantial **adoption costs and contributions to future maintenance** of public infrastructure and facilities must be controlled and severely curbed;

- **Transport policies** designed to change consumer behaviour should be funded by the state, not by residential land value;

- There is no excuse for the **additional costs** imposed on development by planning delay and inefficiency, and by the shortages of permissioned land artificially created by local planning authorities.

The scale and cost of policy and regulation is one of the most important differences with the post-1992 housing recovery when regulatory costs were low, and so had little impact on viability. As the market recovered and house prices began to rise, this immediately fed into improved profitability and land values. Today, regulatory and policy costs will have to be overcome before profitability and land values can be rebuilt on many sites, thereby acting as a major brake on house building growth.

Local planning authorities have a key role to play in relation to viability. To ensure they have a five-year deliverable, viable land supply, as demanded by Planning Policy Statement 3 (PPS3), they need to work with the industry to make realistic assessments of site viability. If sites in their five-year assessments are no longer viable, other viable sites will have to be identified. Local authorities also need to be pragmatic about S106 and other policy demands. Unless these are scaled back for both existing permissions and new sites, the house building recovery will be held back. And, as noted above, local authorities will have to be flexible about densities and mix as house builders re-plan sites in the light of current market conditions.

Another part of the vision for the future should be to consider what alternative means of financing public policy objectives might be feasible and desirable, and whether such mechanisms could also help create a more positive climate for development. For example, there is currently much interest in Tax Increment Financing. This and other models, which enable local government to raise finance and effectively partner development, could potentially work on two levels, by reducing the squeeze on viability, and by creating a better alignment of interests in favour of development at local level.

Before leaving this subject, it is perhaps worth addressing two comments that are often made about house building.

First, it is sometimes claimed that house builders are inefficient, do not innovate, and therefore their constructions costs are too high. The implication is that by simply becoming more efficient, and cutting their own costs, they could afford to meet the costs of policy and regulation.

We are not aware of any solid evidence to support this claim, whether for the UK itself, or by comparison with costs in other countries. Indeed, given the persistence of such beliefs within Government, we believe CLG should undertake a comparative international study of housing constructions costs, including the costs of policy and regulation. If this research did find that UK house building costs were relatively high, it is quite likely most of this additional cost would reflect the higher costs of policy and regulation.

In addition, claims that UK house building costs are too high because house builders are inefficient are implausible because there are such strong competitive reasons for house builders to contain these costs. Land is the lifeblood of a housing developer, and almost all land is acquired in a competitive situation. This puts pressure on every house builder to contain costs because every saving on costs can be put into the land value, and so increase the success rate for land bids. An inefficient house builder, with high construction and other costs, would be uncompetitive in the land market, and so would run out of land and go out of business[38].

Second, observers sometimes ask why house builders do not cut their profit margin, thus freeing up development value to pay for policy and regulation costs. House building is a high-risk business and, as amply demonstrated over the last few years, subject to violent cyclical changes in market conditions. The returns house builders must earn are dictated by share holders who expect a risk-adjusted return that is competitive with alternative investment options. In City eyes, “housebuilding is one of the lowest rated sectors, which reflects historic concerns relating to the volatility of the housebuilders’ earnings”[39]. A house builder offering its shareholders a consistently low return would go out of business or be bought by a more profitable competitor.

4.5 Industry Delivery Capacity

Lost capacity in the house building, subcontracting and supply industries will take many years to rebuild, thus acting as a constraint on the speed with which the industry can lift completions.

Home building industry capacity has been seriously reduced by the housing crisis, as has capacity in the supply industries.

Companies have reduced their housing output, in many cases very significantly, and they have scaled back their business capacity accordingly. Housing forecasters currently expect total housing starts in Great Britain to fall below 100,000 in 2009, less than half the peak of 215,000 in 2006. This has meant the loss of large numbers of people, skills and skilled teams. Many regional offices of larger companies have been closed, and many smaller companies have withdrawn from house building, or not survived at all. Based on an academic study for HBF in 2005[40], we estimate that there were around 335,000 people directly employed (office and site) in home building in the UK at the peak in 2007. The scale of staff cuts by some of the major home builders suggests somewhere between one third (110,000) and half (170,000) of industry jobs could have been lost since 2007.

---

[38] Land values are the residual between the total value of the homes on a site (the gross development value) and the total cost of providing the homes. A house builder with a high cost base would therefore generate low residual land values, and so be outbid by other house builders in the land market.

[39] *The Callcutt Review of housebuilding Delivery.* Communities and Local Government, November 2007

[40] Michael Ball. *The Labour Needs of Extra Housing Output; can the housebuilding industry cope?* HBF and ConstructionSkills, March 2005. There are no official statistics for employment in house building.

Development finance availability has been severely curtailed, its cost has increased, loan-periods have been reduced, loan-to-value ratios have been tightened, and the more heavily indebted firms are having to reduce their debt levels. It is likely to be some time before development finance is readily available for the industry, not least because the banking sector as a whole is overweight in property (commercial and residential), and so will be reluctant to increase its exposure to the property and development industries. Higher bank capital requirements, through UK regulation and any revisions to Basle II, could also have an impact on the availability and cost of development finance.

The industry requires capital to fund the substantial costs of progressing long-term strategic and regeneration sites through to a successful planning permission, to purchase development land, and to fund work in progress. If capital availability remains constrained, if it is more expensive than in the past, and if loan terms remain tighter, this will have an impact on each of these development stages.

The depth and duration of the recession, and uncertainties about Britain's economic outlook, are also likely to make companies cautious about expanding capacity and output. At the very least, house builders will want to be certain Britain's economy has reached a period of sustainable growth before contemplating gearing up capacity to achieve a higher level of output. In the early stages of the recovery, many companies are likely to try to expand output by opening up new sales outlets using their existing capacity, only opening new offices and taking on new skilled teams once they are convinced the recovery is sustainable.

For building material and product suppliers, expanding capacity can involve major, long-term investment decisions. Such decisions will require a high degree of certainty about the likely future growth rate of house building.

Because capital is likely to act as a constraint on residential development for some time, the industry will need to seek creative ways to reduce its capital requirements. Partnerships with local authorities, public sector agencies, RSLs or private land owners or land developers would seem to offer considerable benefits. If these organisations contribute land to a joint venture or partnership, in exchange for a share in the development profit, a house builder's capital requirements will be significantly reduced. The HCA, in its role managing the disposal of large areas of public sector land, will have an important part to play[41].

It should perhaps be noted that ill-informed calls for local authorities to contribute land "free" are not helpful. There is no such thing as free land. All land has an opportunity cost. However, given likely future capital constraints, it may be better in some cases for local authorities – or other public sector bodies – to put land into a joint venture with a developer in return for an ongoing share in the development profit (and risk), rather than trying to sell the land outright for the highest immediate price.

Smaller companies, which make a valuable contribution to housing production, face particular barriers to entry and capacity constraints. According to NHBC statistics, companies building less than 100 units per year account for about a quarter of housing starts.

[41] The HCA is currently exploring possible partnership arrangements for the development of public sector land with its Public Land Initiative and Delivery Partner Panel.

The availability of development finance has had a damaging impact on many smaller companies. Unless this constraint eases, it will limit their ability to expand output in the recovery. Smaller developers usually have relatively small land banks, living "hand to mouth", so they will require capital quite early in the recovery if they are to acquire land and expand their businesses.

The emphasis of some local development plans on large strategic sites can limit the supply of small sites, the lifeblood of most smaller developers. It is difficult for these companies to compete for phases of large sites because they do not benefit from the significant cost economies of scale achieved by large developers. Some local authorities have policies restricting development in smaller settlements, which limits the supply of small sites.

The complexity and cost of the planning system, the impact of policy and regulation on viability, the enormous new technical and viability challenges posed by the zero-carbon target for 2016, the cost implications of frequent revisions to Building Regulations, the capital requirements of apartment developments, and the complexity and higher costs of some brownfield development, all tend to have a particularly severe impact on smaller developers who have limited manpower and cash resources.

4.6 Productivity, Efficiency and Costs

Given the environment in which UK house builders operate, we do not believe there are significant building efficiencies or new production methods waiting to be adopted by home builders which would significantly reduce costs to free up land value to pay for public policy demands.

Innovation and productivity gains will help the industry raise housing output, although progress must have been damaged by the severe house building slowdown, both in the home building industry itself and in its supply industries. This is particularly unfortunate because it has coincided with the run up to zero carbon in 2016. Entering the uncharted territory of zero carbon requires substantial research and innovation by the industry and its suppliers.

Given the absence of any statistics, it is difficult to pin down how much research and innovation is undertaken by the industry, or the scale of productivity improvements. However it is possible to reach some sensible conclusions.

In a study for HBF and ConstructionSkills, Professor Michael Ball concluded that higher volumes should bring productivity improvements. In a section entitled 'A potentially virtuous productivity circle arising from higher volumes', he said:

> "Significantly higher housebuilding volumes are likely to increase the incentives to raise efficiency, quality and training, and to provide what consumers want by unleashing the forces of competition and economies of scale…Such volume effects have been observed in many other industries and countries in the past and might be what the UK housebuilding industry needs in order to become much more productive. Higher volumes of housebuilding

by themselves consequently may lead to lower labour inputs per unit of output”.[42]

If Professor Ball was correct, then the steep fall in house building activity in 2008 and 2009 will have had an adverse impact on productivity.

It was argued in section 4.4 that house builders are under intense competitive pressures to keep down house building and development costs. We are not aware of any evidence to support claims that house builders are inefficient, high-cost and resistant to new production methods.

The production methods used by UK house builders have evolved in response to the external conditions in which companies operate. A number of external factors have a major influence on production methods.

Because there is so much uncertainty about the outcome of local authority planning decisions, house builders frequently do not know whether a scheme will obtain planning consent until the day the local authority has taken the decision. This means it is impossible to plan ahead for a known construction start date.

To contain work in progress, the pace of building homes for sale is dictated by the pace of sales. While in theory it might be less costly to build more quickly, in practice this would mean that housing production would run ahead of sales, and so incur substantial additional cost from a build up of work in progress and unsold stock, thus negating any efficiency savings from faster construction. This is in contrast to contracting work where a contractor is commissioned by a client (e.g. a housing association or a commercial client) to build a project to a fixed timetable.

Standardisation is one of the core requirements for production efficiency in any industry. Yet this is very difficult to achieve in UK home building for a number of reasons.

The industry’s total output is, by comparison with many other industries, relatively small. Even at the peak of the market, GB housing completions totalled only 209,000. Most manufactured products are produced in much greater numbers, allowing greater economies of scale. The home building industry has several thousand sites under production at any one time, many with quite small numbers of homes. The largest companies have around 300-400 active sites. So the economies of scale achieved in most industries, which concentrate production in a small number of large factories, are not possible. On most sites, the house builder will try to have a variety of house types to cater for as wide a market as possible, and so maximise sales. So the relatively small number of homes produced nationally is further subdivided into many individual products, on many individual sites. Local planning authorities frequently demand ‘local’ variations to a house builder’s products (e.g. design requirements, materials specification), taking house builders even further away from standardisation. And many brownfield sites, which now account for around three quarters of all housing production, require bespoke

[42] Michael Ball. *The Labour Needs of Extra Housing Output; can the housebuilding industry cope?* HBF and ConstructionSkills, March 2005

designs to fit the local market and special site conditions. All these influences make standardisation very difficult to achieve.

While there may be alternative production methods which would, in theory, be more efficient and less expensive, house builders' methods of production have evolved in response to real-world conditions - planning uncertainties, the need to build to sale, limited scale economies, limited opportunities for standardisation.

4.7 Business Models for Housing Delivery

The vast majority of new housing required to meet the Government's targets will have to be developed by private house builders for private buyers, acting alone or in partnership with land owners. It is difficult to believe there are any new business models waiting in the wings for the simple reason that any organisation attempting to develop housing would face exactly the same risks and constraints as traditional house builders.

As already discussed, a large majority of British households want to own their own home. In addition, severe constraints on public spending and borrowing over the next decade must rule out major public sector house building or housing subsidy programmes. Therefore the development of market housing for sale by private developers will continue to dominate overall housing provision.

There is an important distinction between the **new housing delivery model** and the traditional house builders' **business model**.

The delivery of new housing involves a series of steps: identifying and assembling suitable land, assessing local demand or need, designing an appropriate scheme, obtaining planning permission, constructing the homes, and either selling them to investors or owner occupiers, or managing them as rented homes. There are five major risks involved in these steps: planning, construction, sales, market and, since 2007, availability of capital[43]. Whatever business models are used to deliver housing, these risks must be carried and priced accordingly. Risks can be transferred, by rarely eliminated.

In the UK, traditional house builders have usually undertaken all these steps except management of rental housing, and so have taken on all the major risks which have to be priced into their profit calculations. In other countries, different business models are followed. For example, in some European countries many individual home owners commission their own home from a house builder. In the United States and Australia, land developers are common, with house builders concentrating on building and selling homes, so that the major risks are split between the two different players.

Although some observers have claimed that the traditional house builders' current trader business model is 'broken', it has served the industry and housing supply well for a century or more, and there is no reason inherent within the model itself which suggests it will not survive as the dominant delivery model far into the future. Even if

[43] The sales risk is that the home builder may misjudge the local market by building the wrong products at the wrong prices to meet local demand. Market risk refers to unanticipated changes in market conditions, such as a sudden rise in interest rates or a sudden contraction in mortgage availability.

restricted capital availability leads to more partnerships, bringing in additional sources of capital, this will not change the basic housing development model.

There have also been claims that new types of organisation will need to be brought into housing development, such as contractors, commercial developers or foreign developers. House builders cannot object to competition from new entrants, as long as everyone operates on a level playing field. However these claims often ignore several of the stages in housing development and key areas of risk, concentrating on only one or two steps in the housing delivery model.

Last year's OFT market study[44] into the homebuilding sector concluded there were no competition issues in the sector:

> "Our study found little evidence of competition problems with the delivery of new homes in the UK."
>
> "We found no evidence that individual homebuilders have persistent or widespread market power or that they are able to restrict supply or inflate prices."
>
> "We have not found any evidence that homebuilders have the ability to anti-competitively hoard land or own a large amount of land with planning permission on which they have not started to build."

So there does not appear to be anything house builders themselves are doing which restricts new entry or the expansion of existing firms. The market has always been open to different types of organisation. The fact that there have been so few significant new entrants over the last decade or more suggests, however, that there are barriers to entry external to the industry itself.

These barriers must include restricted land supply, the complexity of the planning and regulatory environments and the costs they impose on housing development. Smaller and medium sized firms are also likely to be deterred by the costs, complexity and regulatory burdens on residential development.

Claims that other types of companies should be encouraged to enter the market in order to achieve what house builders cannot achieve seem highly questionable. Foreign developers, contractors or commercial developers would face exactly the same shortages of permissioned land, policy and regulatory complexity and costs, planning complexity and delay and capital requirements as traditional house builders. In the buoyant years from 2000 up to 2007, only one major foreign housing developer entered the UK and European housing markets, and it eventually sold its UK investment and retreated back to the US. There was ample opportunity for UK or foreign contractors or commercial developers to enter the market during these good years, but none did on any significant scale. Those commercial developers which have assembled large residential sites, usually as part of large mixed-use developments, tend to act as land developers, eventually selling serviced parcels of land to traditional house builders, rather than getting involved in house building themselves[45].

---

[44] OFT. *Homebuilding in the UK; a market study*. September 2008
[45] The notable exceptions are Lend Lease, which owns Crosby Homes, and Quintain which is developing its Wembley site.

The housing association sector faces serious constraints. The Affordable Housing funding model developed over the last decade or more, based on grant from central Government (via the Housing Corporation or HCA), private subsidy out of residential land value through S106 agreements, cross subsidy from shared ownership and market sales, and ready access to private finance at very keen rates, is no longer viable. A new model for funding and delivering Affordable Housing will have to be devised. Any such model will have to take account of the Government's mixed communities policy which requires a mix of incomes and tenures on larger housing developments.

Recently, local authorities have been encouraged to undertake housing development in their own right. While a few are becoming active developers, and many own potential residential development land, it is difficult to believe the local authority sector as a whole will be able to make a significant contribution to meeting the housing targets, at least in the short to medium term. Few have any development expertise, and extreme pressures on public finances and borrowing will restrict their ability to raise funds for development.

The alternative business models sometimes proposed appear to rest on wishing away some of the constraints faced by housing developers, addressing only a limited number of the steps involved in housing delivery, or ignoring or under-pricing some of the risks involved in housing delivery.

For example, as discussed below, proposals to encourage private rental development by eliminating planning constraints such as planning obligations (S106) and affordable housing demands simply wish away planning constraints for one particular tenure or rental provider. Claims that local authorities or RSLs should buy up house builders' land holdings at today's very low land prices solve nothing. Even if house builders would sell their land, ownership of land without capital and expertise does not produce housing. In last year's report on homebuilding, the OFT said that the three databases it used "suggest that the public sector accounts for between a quarter and a third of all land currently deemed suitable for residential development"[46]. If land ownership was the only constraint on public sector housing delivery, the public sector should have been developing large numbers of new homes in the boom years up to 2007. It has even been suggested that local authorities are ideally placed to develop housing because they can easily give themselves planning permission on land they own. It is difficult to take this proposition seriously. Contractors, whether UK or foreign, have no expertise in land assembly, designing marketable schemes, planning or sales, and it is not at all clear why a contractor would wish to take on all these roles, with their attendant risks, and certainly not at a contractor's margin.

Those who propose alternative business models have a responsibility to explain how any new model would deal with <u>all</u> the stages in the housing delivery process, and how <u>all</u> the major risks involved in housing delivery would be dealt with and correctly priced.

4.8 Meeting the Housing Needs of First-time Buyers & Intermediate Households

Because tighter mortgage regulation will constrain many first-time buyers' ability to access home ownership, and because the supply of social housing

[46] OFT *Homebuilding in the UK. A market study*. September 2008

for rent will be severely limited by public spending constraints, the Government should examine incentives for first-time buyers and the private rented sector needs to expand.

From a demand perspective, the tenure profile of new housing output may have to change over the next few years.

Even when mortgage funding is restored, greater lender caution and tighter regulation seem likely to limit mortgage availability for first-time buyers, investment buyers, lower income households, the self employed and those with an impaired credit record. But these people will still have to be housed.

One option would be simply to accept that they will not be able to form independent households, leading to sharing and overcrowding.

For example, young people will have to live at home with their parents, or live in shared accommodation, for much longer than in the past. In cases of separation and divorce, adults may have to move back with their parents or live in shared accommodation. As noted in 3.5, official statistics show that in the second quarter of 2008, 29% (1.8 million) of men aged 20-34, and 18% (1.1 million) of women of the same age, lived with their parents[47]. Since 2001, these numbers have increased by nearly 300,000. So the long-lasting effects of the credit crunch and tighter mortgage regulation will come on top of an already established shift.

However if we want these groups to be able to form independent households, they will have to be helped to find housing in the owner-occupied sector or the rented sector.

Because poor affordability and the impact of permanently tighter regulation on mortgage availability and terms will make it difficult for many young people to take their first step on the home ownership ladder, especially those without access to financial help from family, the Government should explore measures to assist first-time buyers. These might include tax incentives to encourage young people to save for the deposit on a home, mortgage interest relief on a time-limited basis, or grants towards a deposit. The US Government introduced a tax credit of up to $8,000 for first-time buyers (available between 1 January and 1 December 2009). Recent news reports suggest the tax credit is having a positive impact on the housing market.

Such measures would not only help the households directly involved, but first-time buyers are essential to a healthy housing market because every chain must have a buyer at the bottom whose purchase is not dependent on a sale.

It is difficult to see how social housing provision, which requires heavy public subsidy or land-value subsidy, can be expanded sufficiently to meet the needs of these households. There is going to be unprecedented pressure on public expenditure and borrowing once the British economy begins to recover, and it is going to be a long time before higher house prices restore the residential land value subsidies on many sites that were available for Affordable Housing up until 2007.

[47] Office for National Statistics *Nearly a third of young men live with their parents*. News Release, 15 April 2009

So if these households' access to home ownership is delayed, or possibly blocked altogether, and if they cannot find housing in the social rented sector, they will need to seek a home in the private rented sector.

There is considerable doubt that buy-to-let demand, dominated by small-scale private landlords, will recover to pre-recession levels. Therefore we need to find an alternative supply model for the private rented sector.

Governments have been trying for nearly three decades to create a large-scale, professional private rented sector, funded by long-term institutional finance. This would now seem to be a priority, given the housing outlook for intermediate households. There are no easy answers, but house builders have a critical role to play in any solution because they will have to provide most of the housing for the sector. If it can be made to work, an expanded private rented sector would create a new source of demand for new homes, replacing the shortfall left by the decline in buy-to-let demand, and helping to underwrite major regeneration projects.

The fundamental barrier to establishment of an institutionally funded, professional private rented sector is restricted land supply.

Asked why an institutionally-funded private rented sector has not become established, most experts will respond simply: yields. Because local rents are a function of incomes, and must therefore be taken as given, this answer essentially means capital values are too high in relation to local rents. Buy-to-let landlords moved into the sector in large numbers from the late 1990s because they accepted low rental yields in exchange for high anticipated capital gains in a booming housing market. Institutional funds, by contrast, tend to seek a high rental yield, with a modest contribution from rising capital values.

UK residential capital values are high over the longer term because the supply of housing is so restricted. It should be no surprise that the primary long-term cause of affordability problems in the owner-occupied sector – a highly restrictive planning system which rations the supply of residential land and keeps the capital value of housing high – is also responsible for the failure to establish a thriving institutionally-funded private rented sector.

> To understand the yield problem, it is instructive to compare the commercial and residential property sectors.
>
> A commercial property developer, or an institution seeking to invest in commercial property, will start with a required rental yield and the rent achievable for a particular development. From these two variables, the investor will derive the capital value that can be paid for the development (to cover land, building and funding costs) to ensure the required yield is achieved at the given rent.
>
> By contrast, residential capital values are determined primarily by the prices owner-occupiers will pay in the housing market, rather than rental investors. A residential developer building for the owner-occupied market has to take capital values as largely given, with rental values playing no part in a development appraisal. Residential land values are the residual between the market value of the new housing on a site and the cost of developing the housing.

A problem emerges in the UK when trying to apply a commercial, yield-driven approach to the residential market. By starting with a rental yield and taking local rents as given, the resulting capital value that can be paid for a dwelling by a rental investor will, in most markets, be lower than the owner-occupied market value, and so lower than the value a residential developer will need to achieve to cover the cost of buying the land and developing the homes. Put the other way round, if we start with the capital value set by the local owner-occupied housing market and with local rents, the resulting rental yield will be too low to satisfy an institutional rental investor.

Of course there will always be some segments of the rental market in which high-income tenants pay sufficiently high rents to make rental yields work. However we need supply to cater for a broad market, offering affordable rents for middle and lower-income households. If the rental stock is inadequate to meet demand, rents are likely to rise. While this would improve rental yields, it would price some renters out of the market. Also, if it was accompanied by a rise in house prices, this could negate the yield benefit of higher rents.

These observations refer to longer-term trends. It may be possible in today's depressed market to acquire new residential units for the private rented sector at an acceptable rental yield. However these are very exceptional times, and discussions with experts suggest even today it is very difficult to develop housing profitably at values which yield an institutional investor an adequate rental return.

Most proposals for solving inadequate residential rental yields revolve around trying to lower capital values (land and buildings) or the other costs associated with establishing a rental portfolio.

Changes to SDLT and to the VAT treatment of rental housing repairs would help. However, on their own, these are unlikely to restore yields to an adequate level.

A number of proposals, such as creating a special planning use class, treating private rental housing as Affordable Housing for planning purposes (and so not subject to a separate Affordable Housing requirement), or allowing private rental developments to avoid Affordable Housing and other S106 contributions altogether, effectively amount to using the planning system to reduce the total cost of providing private rental housing. However it cannot be right to use the planning system to manipulate land values in favour of one tenure, or in fact in favour of one type of housing provider within one tenure.[48] Indeed, there is a strong argument that the planning system should not be used to influence the tenure of housing at all - it should be "tenure blind". There should be a level playing field in planning terms between owner-occupied and private rented housing, and between different types of housing providers.

The only long-term solution to low rental yields in the private rented sector is the same as the solution to poor affordability in the owner-occupied sector: allow an adequate supply of permissioned residential land to bring the supply of housing into balance with demand and need. Any other solution amounts to

[48] Suggestions to use planning to manipulate land values in favour of one tenure, or one type of housing provider, are particularly ironic because it is the planning system itself which, by rationing the supply of residential land, has created the rental yield problem in the first place.

trying to rearrange the passengers in the lifeboats when the real problem is that there are not enough lifeboats.

However, in the short term we welcome the HCA’s initiative to stimulate interest in the private rented sector. It is only by attempting to make real schemes stack up financially, and by bringing together institutions, private rental funds and private developers, that we will achieve a full understanding of the barriers to the sector.

Given the potential benefits to home builders, HBF will continue to work with the HCA, housing developers, financial institutions and residential funds to explore whether rental schemes can be made to work, and to try to identify policy and taxation measures that could help encourage supply.

John Stewart
25 August 2009

Appendix
The Cumulative Impact of Taxation, Policy and Regulation on Residential Development Viability
Recommendations

There is a long list of taxes, polices and regulations, imposed by central government, local authorities and other agencies, which add significantly to house building costs, but which do not create a compensating increase in sales value. These costs ultimately have to be funded out of land values, thus reducing the value available to pay land owners, and so reducing the number of homes being developed.

This Appendix categorises the many policies, taxes and regulations which have to be funded out of land values, and then suggests measures that could be taken to reduce these costs in order to improve the viability of residential development and allow house builders to increase delivery.

For some measures on the list, such as zero carbon or Affordable Housing, the full cost of the policy is additional to the normal development costs of producing market housing. In other cases, such as local authority public open space or design requirements, the cost impact comes from demands over and above what the developer would provide purely in response to market requirements

1. **Direct Site Impact Mitigation**

Flood protection
Ecology
Off-site highways
SUDS (Sustainable Urban Drainage Schemes)
That part of the Community Infrastructure Levy (CIL) attributable to individual sites

Solution
House builders fully accept that the costs of **direct site mitigation** should be paid for out of site land value; but unless alternative sources of funding are found for the many additional regulatory and policy costs, there will be insufficient land value available to fund site mitigation, so that fewer homes will be built.

2. **Site-specific Sustainability**

Zero carbon (Part L of the Building Regulations)
Code for Sustainable Homes (other elements of the Code than Part L)
Water conservation measures
On-site renewables
Climate change adaptation measures

Solution
If central and local government want new homes to meet world-beating sustainability standards, these very significant costs will require alternative sources of funding if they are not to be at the expense of many other policy objectives (most notably the big-cost items Affordable Housing and community infrastructure provision). House builders should be concentrating on efficiently building energy-efficient homes to meet consumer demand, not learning how to become energy providers.

3. **Site-Specific Design Demands**

Space standards
Lifetime Homes

Density and mix policies: where the resulting density and mix of house types are out of line with what the local market would require
Building for Life (BfL)
Public open space and public realm
Play space

Solution
Site-specific design demands above and beyond the requirements of home buyers should be curbed, and local authorities should be fully aware of the impact of such demands on costs, building efficiency, land viability and supply and housing supply;

4. **Community Infrastructure and Services (S106 and CIL)**

Community buildings (e.g. village hall)
Education contributions
Fire service contributions
Libraries contributions
Health contributions
Rescue services contributions
Allotments
Cemeteries
Playing fields
Contributions to off-site renewables

Solution
The public sector should pay for community infrastructure (e.g. education, health, etc), out of general taxation as it always was before S106 agreements became widespread.

5. **Affordable Housing Subsidy**

Affordable Housing provided through S106 planning obligations agreements

Solution
This is one of the largest cost burdens on residential land values. It is not at all clear why residential land value should provide subsidy for Affordable Housing (commercial land value rarely does). Housing for those who cannot afford market housing should be subsidised by the state, as it always was until S106 agreements became widespread. If the Government wants to create mixed communities on larger housing sites, it should purchase housing from developers for the market price.

6. **Taxes**

Landfill Tax
Empty Property Rates
SDLT
Capital Gains Tax
Local Business Rates
Business tax on show homes

Solution
The Treasury must include all forms of residential development taxation in the report on policy and regulation for the *Pre-Budget Report* so that the Government has a complete picture of the state's demands on land value, and where possible moderate its demands

7. **Adoption Costs**

S38 local highways commuted sums (to pay for future maintenance)
Public open space commuted sums
Bonding
Play area adoption costs
Bridge adoption costs, etc.

Solution

It is not at all clear why land value should pay for future maintenance of public infrastructure or facilities. These demands are largely unregulated, are levied by public bodies with monopoly powers which are very difficult or impossible for developers to challenge or avoid. They must be brought under control and severely curbed.

8. **Transport Policies**

Green travel plans
Bus subsidies for uneconomic services
Cycleway provision or contributions
Railway stations, etc.
Park and Ride provision or contributions

Solution

These policies are about changing consumer behaviour, not mitigating the impact of development. It is not clear why development land value should fund such aspirational policies. If the state wants to change people's behaviour, it should fund these policies.

9. **Planning Inefficiency & Delay, Land Supply Restrictions**

Uncertainty arising from delays in preparing LDFs
Uncertainty about policy (e.g. S106) demands
Uncertainty in planning application outcomes
Delay in reaching planning decisions
Land shortages created by planning restrictions

Solution

None of these is a deliberate policy demand, but each case the state's actions add cost to residential development. Unnecessary delay and inefficiency adds to development costs, as does uncertainty about policy demands when buying land. Uncertainty about the outcome of planning decisions means developers have to process more sites than would otherwise be necessary for any given level of output. Permissioned land shortages drive up land prices, and so increase developers' capital requirements and financing costs. Local authorities should be made far more aware of the adverse impact of their behaviour on costs and housing delivery. The Killian Pretty Review findings should all be implemented urgently, and further measures considered to reduce unnecessary costs on development.