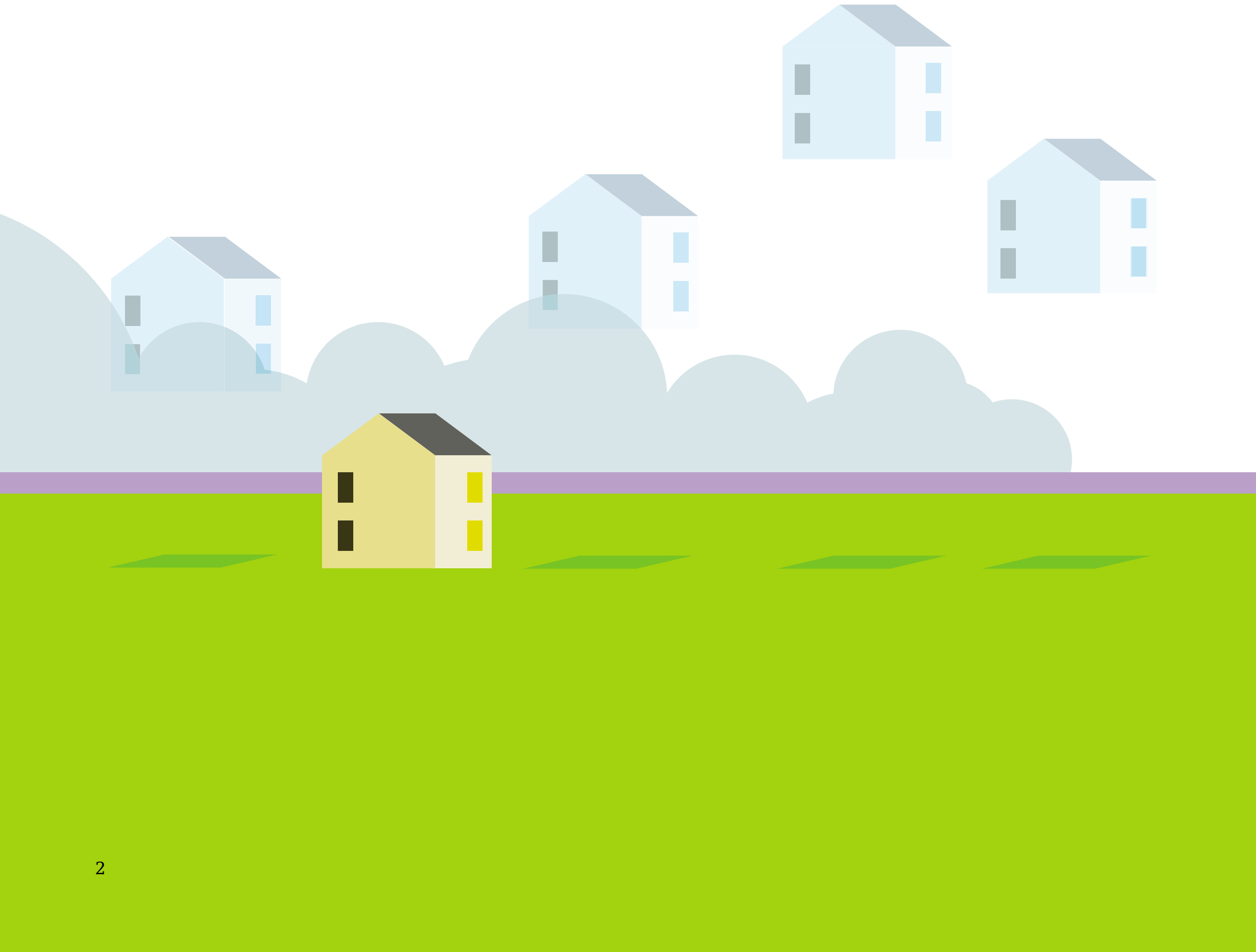
The UK is facing not one but two housing crises, according to **Henry Overman**. The first is a short-term fall in prices and construction – which is both driven by and driving the recession. The second and more profound is the overall shortage of housing and the problems of affordability that this generates.

The UK's housing crises



The UK was building very few houses even when the economy was booming

Reduced demand during the recession has been reflected in falling house prices outside London and the South East and a slump in construction everywhere. Data from the Department for Communities and Local Government show that between their peak in 2007 and 2011, house prices fell by 12% in the North East and by 10% in the North West. Between September 2011 and September 2012, land registry data show further price falls of 3.2% in the North East and 2.2% in the North West.

There has also been a severe slump in construction in these parts of the country. In the North East, construction (measured as permanent dwellings completed) has fallen by 36% from its 2007/08 peak. In the North West, construction has fallen by 47%.

Prices have held up much better in London and the South East. A large initial fall in London (9.3%) was quickly offset by subsequent rises, leading to an overall increase of 3.8% between 2007 and 2011. The South East saw a similar initial fall and a slightly weaker recovery, but prices still increased by 1.4% between 2007 and 2011. Between September 2011 and September 2012, land registry data show a continued recovery with prices rising by 5.5% in London and by 2.3% in the South East.

Despite these different price trajectories, construction has still slumped, even if the impact is somewhat less pronounced: 12% down from the peak for London; and 19% down from the peak for the South East.

While we should not downplay short-term concerns about the impact of falling house prices on consumer demand, it is the construction figures that are most worrying. The UK's more profound housing crisis is the overall shortage of housing and the problems of affordability that this generates (see, for example, Hilber and Vermeulen, 2012).

These problems, already acute in the South East, can only be exacerbated by recent trends of slow income growth, falling construction and rising prices. Even with the general price falls in Northern regions, affordability remains a problem for the more successful cities, such as Manchester.

Focusing on the short-run slump also distracts from the longer-run problem that the UK was building very few houses even during the good times. At the height of the boom, England was building 170,000 new homes a year. The annual average between 1998 and 2007 was 150,000 new homes.

To put these numbers in perspective, note that between 2001 and 2011, about 1.4 million new homes were built in England, while the population rose by just under four million. With an average household size of a little over two people per household, it is not surprising that prices rose so sharply. The now defunct National Housing and Planning Advice Unit suggested that we would need to build around 270,000 homes a year just to stabilise (not reduce) prices.

Managing the demand for housing

So what can be done? Some have called for the problem to be tackled 'head-on' by rent control measures to restrict rising prices. That would be great for people who get rent-controlled houses, awful for everyone else. In the long run, it would also massively distort the rental sector (because it reduces the returns to renting and increases the cost of moving). Quite simply, this is a very bad option.

Instead of intervening directly to control prices, an alternative set of measures aims to intervene on the demand side of the housing market. These measures are of two broad kinds. The first seeks to dampen demand, for example, through changes in the way in which housing is taxed. Subjecting housing to capital gains taxes would be a good if very unpopular example.

To the extent that these arguments are about reducing the pro-cyclicality of the housing market (the tendency for demand to rise very rapidly as the economy booms), there is something to recommend them. It is less clear to what extent they would solve the fundamental problem because most suggestions would have little effect on existing homeowners, but instead reduce demand from younger generations (or renters). With the overall supply of housing fixed, measures to improve affordability need to have precisely the opposite incidence.

This leads to the second kind of demand-side intervention: policies to increase demand. As with policies to dampen demand, whether this helps in terms of affordability depends on the extent to which it redistributes the ability to demand housing from the house 'rich' to the house 'poor'.

Once again, many recommendations are likely to work in the wrong direction. For example, the Smith Institute has suggested that the government should consider tax concessions along the lines of mortgage interest tax relief (Miras, which was abolished for principal residences in 2000) to encourage access to home ownership.

Unfortunately, US evidence suggests that there is only a very weak link between mortgage interest relief and home ownership (Hilber and Turner, 2010). In fact, in tightly regulated housing markets, relief has a negative effect on home ownership because the price effect (through increased demand) more than offsets the income effect (from the tax deduction). In less regulated markets, relief does have a positive effect on home ownership rates, but only for higher income groups.

As the UK market is very highly regulated, these findings suggest considerable caution in using Miras as a means to increase home ownership. Reintroducing it could prove to be a costly and ineffective intervention, which has the opposite impact of that intended.

Unfortunately, many other demand-side proposals do not stand up to even the most basic scrutiny. The most recent example is Nick Clegg's suggestion that parents should be allowed to use their pension to help younger people buy property. A two-step assessment of this policy (which can, of course, be applied to many other housing policy initiatives) would run as follows.

The system has failed to deliver enough houses of the kind people want in the places where they want to live

First, how many people are likely to be affected? This can be tricky to work out precisely, but for Clegg's announcement – as with a number of recent schemes – the conclusion from a rough estimate seems to be 'not many'. Second, if the policy does affect relatively large numbers of people, what will be the likely impact on the market?

This second step involves applying some basic insights from supply and demand. There are essentially two ways to help people struggling to get a toehold in the housing market. One is to increase the supply of (suitable) housing. The other is to redistribute some of the existing housing stock from older people to younger people. Nick Clegg's proposal does neither of these things – so even if it were to 'work', it would not 'help'.

If it is hard to formulate good demand-side measures when the market is left to its own devices, then another possibility is to intervene directly to redistribute housing. Two popular examples here relate to 'empty bedrooms' and 'empty houses'.

The Intergenerational Foundation has called for the government to adopt measures to stop older people from 'hoarding' housing. Based on an assessment of housing 'need', policies like this argue that we should take bedrooms from people who currently 'under-occupy' their houses and give them to those who live in overcrowded conditions. In practice, this tends to mean getting old people to move out of large houses.

Ironically, the fact that planning decisions are made on the basis of 'need' but housing is allocated through the market is one of the reasons why the housing market is in such a mess. Markets seek to balance supply and demand (rather than need) and it turns out that as societies get richer, they unsurprisingly tend to demand more space not less.

One response would be to switch to a 'needs'-based mechanism for allocating housing. My colleague Paul Cheshire has light-heartedly suggested one option: 'If we are intent on allocating land for each use without regard to price, then logically we need to introduce space rationing. If price does not determine the supply of land, then price must not determine its consumption. Each adult could, for example, have a ration of, say, 40 square metres with dependent children having, say, another 20 square metres each.
We could, if we wanted, even introduce a trading system so young adults or those willing to live in more cramped conditions could sell some of their space ration, perhaps buying back space in later life' (Cheshire, 2009).

The Intergenerational Foundation suggests something that seems less extreme: measures to encourage homeowners to consume less space. These would be of two kinds. The first would strongly penalise people who 'over-consume' space. Such penalties build up from a logic of housing need and are problematic for all the reasons that space rationing would be: who decides how much space is enough?

The second approach would be to remove barriers and distortions that encourage people to over-consume housing. I would have no problems with such measures apart from the fact that they would be highly costly and remarkably ineffective.

Take, for example, the idea of removing stamp duty on people downsizing. At the moment, the huge wealth gain that they would get by moving into a smaller house is insufficient to offset the benefits of staying put. Removing stamp duty would change this balance for a small number of people at the margin, but it would be at a huge cost to the public finances.

Removing single person allowances on council tax or removing universal benefits for those in valuable houses would have a similarly small impact on the number of people willing to downsize. But it would impose high costs on a small number of people who are income-poor and who do not want to move for whatever reason. For more wealthy people, this would essentially be an irrelevance.

Changing the treatment of capital gains tax would provide a disincentive for ownership (which may or may not be a good thing) but it would dampen the incentives to downsize. An annual capital gains tax would constitute a punishment based on arbitrary decisions on how much space is enough.

What about empty homes? In England, there are around 280,000 homes that are empty for more than six months. But for 2011, the data show that only 29,500 of

Policies on 'empty homes' and 'empty bedrooms' do not offer a long-term solution to the housing crisis

these long-term empty homes were in London, with another 32,500 in the South East. In other words, in high demand areas, very few houses are empty.

Using empty homes will (sometimes) make sense, but it will not do much to solve the UK's housing problem. Just as with empty bedrooms, the reallocation of empty homes does not represent a long-term solution to the housing crisis.
So what can be done? The short answer is that we must do things to increase the supply of housing.

Increasing the supply of housing

The under-supply of housing in the UK has been a long-term problem, which the previous government was unable to tackle effectively. Labour was slow to recognise that something needed to be done about the planning system. Once the problem became clear, top-down regional plans were introduced, which tried to force local authorities to build more housing.

These plans were very unpopular with local authorities in parts of the country that needed more housing and were quickly abolished by the coalition government. The new 'national planning framework' intends to replace the top-down system with more 'localism' and a package of financial incentives to encourage development – with a target of 240,000 new homes to be built each year (see Nathan and Overman, 2011).

These reforms should be welcomed for a number of reasons, but the government may yet regret the immediate abolition of regional plans. Uncertainty creates problems for developers who tend to respond by postponing investment until that uncertainty is resolved. Add to this the effects of the recession and you have two underlying reasons for concerns about the supply of housing.

In addition to these short-term issues, there is the longer-term issue of what the government will do if its package of financial incentives is insufficient to encourage more development. With the new system yet to bed in, it could be a few years before the government is able to assess whether the system is working. The assessment is likely to be close to an election, when a change of government could see a change of policy and yet more uncertainty for developers.

Another area with which the previous government struggled was its insistence on high brownfield targets. There are some problems with these targets, but they remain very popular. This means that there is a danger that the coalition government will not be able to resist calls to strengthen constraints on building on greenfield land. The government has already committed to maintaining green belts, but there are many other categories of 'protected land' where long-term policy remains uncertain.

But truly dealing with the problem of affordability requires a market-led response in the areas of highest demand. This in turn requires the planning system to allow a proper supply response. Addressing long-term affordability is not a matter of short-term stimulus. Instead, it requires a private sector response when the market finally picks up. Developing a planning system that allows that to happen is the real challenge.

In all the debate around the government's planning reforms, we are in danger of losing sight of the fundamental problem: the current system has failed to deliver enough houses of the kind people want in the places where they want to live. Supposedly 'radical' solutions are either insufficiently important to make much difference (empty homes) or so radical that it is hard to believe they represent a good solution (empty bedrooms). The real solution is straightforward: build more housing.

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For more commentary on housing and other urban and regional policy issues, see the SERC blog: http://spatial-economics.blogspot.co.uk/

Further reading

Paul Cheshire (2009) 'Urban Containment, Housing Affordability and Price Stability – Irreconcilable Goals', SERC Policy Paper No. 4 (http://www.spatialeconomics.ac.uk/textonly/SERC/publications/download/sercpp004.pdf).

Christian Hilber and Tracy Turner (2010) 'The Mortgage Interest Deduction and its Impact on Homeownership Decisions', SERC Discussion Paper No. 55 (http://www.spatialeconomics.ac.uk/textonly/SERC/publications/download/sercdp0055.pdf).

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Max Nathan and Henry Overman (2011) 'Assessing the Government's Proposals to Reform the UK Planning System', SERC Policy Paper No. 11 (http://www.spatialeconomics.ac.uk/textonly/SERC/publications/download/sercpp011.pdf).

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