

SA422: HOUSING ECONOMICS 2008/2009
SA4C7: UNDERSTANDING HOUSING FINANCE AND ECONOMICS
The Impact of Government Intervention in Housing

I Introduction: Mechanisms, Objectives and Outcomes

1. Objectives of government intervention: improve the efficiency of the housing system; overcome market failures; redistribute resources to produce more equitable outcomes. Secondary effects of the housing system from policies aimed at meeting other objectives. Political and other objectives. Problems of implementing change. Result “dog’s breakfast”?
2. Methods of intervention:
 - i) improve the operation of the market – legal framework; provision of information etc;
 - ii) regulation: standards, controls etc;
 - iii) taxation and subsidy;
 - iv) replacement of the market by direct provision and allocation.
3. The same efficiency effects can, in principle, be achieved through the use of regulation, taxation, subsidy or direct provision. The choice of techniques depends on the attributes of the actual problem, information requirements, the capacity to enforce decisions under different environments, the legal and cultural framework, practical policies and many other factors.
4. Different outcomes in terms of distribution – e.g. the effects of regulation “lie where they fall”; the effects of taxation and subsidy depend on formal and actual incidence, the first of which is often seen as being directly related to distributional objectives, the second of which depends on the extent of responsiveness of demand and supply; direct provision will normally have specified distributional objectives, although again market and administrative responses to decisions will modify these outcomes. Capacity to predict actual outcomes?
5. Examples of intervention:
 - i) legal framework which defines property rights in relation to tenure, security, etc; information about these rights, the availability, quality access and price of housing, information about quality of providers; etc – links between organising markets and other methods of intervention.
 - ii) land-use planning – efficiency reasons – provision of public goods, generating and organising agglomeration economies and limiting external costs, providing “certainty” for private investment etc; distributional reasons; controls to ensure suitable density/income mix; relationship of

controls to prices and therefore ownership. Rent controls and security of tenure mainly for distributional reasons arising from market failure to respond to changes in demand in the face of inelastic supply; efficiency reasons to assist response; negative efficiency effects; mechanism for enforcing legal framework of property rights where market power problems. Environmental health regulations; fitness standards etc. – mainly aimed at dealing with external costs of low investment and consumption of housing but with significant effect on costs and therefore capacity to enforce; distributional implications. Financial regulation of building societies, landlords etc. – capital and liquidity requirements, information, transparency and equality of access.

- iii) mortgage tax relief – to provide an incentive to invest in housing, comparable to that of other investment goods. Improvement grants to provide an incentive to invest and overcome locational externalities. Income related benefits to enable low income households to achieve desired levels of housing and/or incentive to the market to supply.

Taxation rarely used to generate positive efficiency policy in housing as seen as a social and merit good. Two examples: taxation of vacant land; speculative sales. Taxation however has significant secondary effects on housing – example: council tax – charge for local services which affects the relative price of housing. Stamp duty – reduces mobility.

- iv) municipal authority provision of housing to utilise resources efficiently and to control allocation to the needy at an affordable price, thus meeting merit good and redistributional objectives. Direct building maintenance, management etc., administrative monitoring and control, improving information replacing problematic contracting. Local authority enabling and nomination roles - utilise aspects of market incentive and constraint mechanisms while maintaining distributional objectives.

- 6. All government interventionary mechanisms can be categorised within this typology. Many different elements – choice should be based on minimising the costs of intervention, generate greater efficiency in the use of scarce resources and on meeting the desired distributional objectives in relation to well-defined goals (Stephens et al, *Evaluation of English Housing Policy 1975 - 2000*, 2005 DCLG Website) in each category.

II Examples and Analysis of Techniques of Intervention

i) Improving Market Operation

Example: Contract Specification and Enforcement

- 7. Legislating to clarify the nature of property rights, and to change these rights –

- e.g. nationalisation of development rights in 1947 Town & County Planning Act; Housing Act shift from assured to shorthold as basic private rental contract.
8. Introduction of small claims courts, standard contracts etc. to reduce costs of using the legal system, make it more transparent and modify the relative power of landlord and tenant.
 9. Provide lists of landlords, construction firms etc. to reduce search costs increase capacity to enforce contracts and increase costs to suppliers of failing to meet contracts.
 10. Effect of the legislative framework depends on its clarity, the costs of information, monitoring and enforcement. Efficiency and distributional implications linked to the quality of those administering the system, the incentives to meet contractual obligations, the chances of being found out and the incentives and capacity of the other actors to enforce the contracts. Problems of transparency, transactions costs, asymmetry of information and power.

ii) **Regulation**

Example 1: Rent Control

(See especially: *Housing Studies*, Vol. 11, No. 1 Focus Issue on Private Renting (1996; Whitehead, *Scottish Journal of Political Economy* 1998; P. Kemp *Private Renting in Transition* 2004)

11. Usually introduced in response to sudden increases in local demand → rents far above long-run costs of production. (Figure 1) – often wartime measure, notably 1915 across Europe. Security of tenure necessary because incentive to evict tenants and replace with those prepared to make side-payments.
12. Initial benefit to existing tenants; incentive for existing tenants to “overconsume”, potential tenants to bid up prices, suppliers to ask for side payments; avoidance and evasion on both sides of market.
13. How is price set? Usually the price that reigned before the sudden change in demand. If wish not to affect longer term investment should relate controlled price to long term cost of production (Figure 1).
14. Opportunity cost also relates to other opportunities for the existing investment. If price < relevant marginal cost suppliers will not receive rate of return at least equal to that available elsewhere. If not, incentive to reduce investment in market (reduce repairs etc.) and, if another better housing option is available, to shift dwelling to other markets. Given rent control and tax disbenefits in rented sector, movement to owner-occupation and transfer to other uses, leading to reduced supply and reduced quality of provision in controlled market (Figure 2).

15. In UK mix of rent control/security and tax disbenefits to renting led to significant pressure to shift supply out of the rental market. Moreover benefit to consumers has been far larger in owner-occupied sector because of tax benefits as well as range of housing available, security and other attributes of owner-occupation. As a result incentives for both demand and supply to reduce size of PRS and increase owner-occupation. In the past taking off controls resulted in further shifts to smaller equilibrium size of rented market because adjustment has been limited by continuing security. Since 1988 traditional sub-sectors still declining but new markets have developed, mainly addressing short-term requirements, especially over the last few years through Buy-to-Let (D. Rhodes & Bevan M., *Private Landlords and Buy to Let*) but also filling the gap in the provisions of affordable housing through the social sector (Holmans et al, 2004).
16. Within PRS observe low density of occupation in controlled sector, low standards of repair and improvement, low satisfaction with contractual relationship. In uncontrolled sector (including avoidance/evasion sector) prices higher than without rent controls – so potential tenants forced into market sector suffer lower standards and higher prices. Problem exacerbated by actual and perceived risks that returns may not be realised. Role of political risk.
17. Freeing up rents generates incentives to supply at least in the short term. This may be particularly important in reducing vacancy and increasing density of occupation as well as new investment. Longer term problems relating to risk.

Example 2: Building Standards

18. Increased standards increase costs of production and therefore reduce demand and increase price of what is provided (Figure 3). If standards increase both costs and utility to consumers may rise so that be prepared to pay more (D_1 on diagram). However standards often introduced for merit good and social utility reasons rather than private utility resulting in incentives for both sides to avoid/evade and problems of capacity to pay.

iii) **Taxation and Subsidies**

19. The usual reason for subsidy is to expand demand so that output reflects the position where $smu = smc$ (Figure 4). The subsidy can be provided either on demand or supply to achieve the same objective – depends on the form of subsidy chosen by government. Examples of relevant current policies include Housing Benefit, improvement grants, HomeBuy, and indeed social Housing Grant.
20. Example 3: Insulation or improvement grants – given to consumers to improve their properties. The extent to which output increases and price changes depend on (i) size of subsidy and (ii) relative elasticity of demand and supply. In Figure 4a subsidy to consumers leads to reduced price to consumers and an increase in level of provision. In Figure 4b subsidy to consumers leads to increases in price

rather than much expansion of output. In figure 4(c) the subsidy is given in the form of a grant per unit to suppliers. It reduces the price to consumers but increases revenue to suppliers.

Example 4: Income v. Price Subsidies

21. House market analysis suggests other things being equal, income subsidies give higher welfare than equivalent price subsidies, which themselves give greater welfare than administrative allocation plus price subsidy (see Robinson Chapter 8).
22. In Figure 5 original housing choice = q_h , on highest possible indifference curve I given original income and relative prices (budget line aa). Reducing price of housing moves individual up to budget line ab. If force consumption of housing to h obtain utility W on indifference curve I. If allowed free choice given reduced price individual will choose less housing q_h^p at X (point of tangency), so highest possible welfare given relative prices and income on I_2 .
23. However, if instead give equivalent income subsidy but original relative prices relevant budget line = cc passing through X to give equivalent subsidy cost. Allows higher consumption of C as well as H and moves individual on to higher indifference curve I_3 at point of tangency Y – because steeper budget line going through point X, and therefore potential for higher welfare.
24. This approach is the basis of the ‘ideological’ argument that it is always better to give consumer the choice so income subsidies are better than price subsidies.
25. Problems: (a) partial analysis – does not ask about effect of income subsidies on labour/leisure choice and therefore preparedness to work and generate income; (b) price effects from income subsidies – relatively inelastic supply of housing so price of housing would change; (c) price subsidies may allow more redistribution of income than income redistribution itself (political question); (d) may be price subsidy for other reasons – externalities, merit good, social discount rate aspects.
26. UK policy shift from supply subsidies to local authorities and housing associations to demand side subsidies via Housing Benefit. Now reversing somewhat as more grant made available for building affordable homes. However, with demand side subsidies there has been as little or no capacity to adjust consumption, so choice is constrained and higher income is mainly available for the purchase of other goods and services. Only in parts of the private rented sector where there are no rent controls can the market analysis be relevant in that consumers can adjust consumption in response to extent of subsidy.
27. Other important question is whether the impact on investment and output is similar. Strong ideologically and housing system based views (Galster 1997; Yates and Whitehead 1998).

iv) **Direct Provision**

28. Objective is to substitute administrative provision and allocation for market provision because capacity to overcome market failures. Also allows direct redistribution to lower income households and other needy groups to achieve merit good and redistributive objectives. However, may not relate to private valuation and choice so reduces welfare below that achievable through the market, given distribution of income.
29. Direct provision involves three main elements: decisions on investment levels and types of provision; how should resultant provision be allocated; and who should pay.

Example 5: Investment

30. How should level of investment be determined? Ideally invest to point where net present value=0 at social discount rate: internalise investment decision so take account of externalities, difference between private and social discount rates, imperfections in capital market etc. Thereafter should price equal social marginal cost and allocation to those willing to pay?
31. Problems of lack of incentive to productive efficiency leading to higher costs per unit than necessary, inappropriate levels of management and maintenance, supply based provision rather than responsive to consumer demand. Relative importance of productive and allocative efficiency (Figure 6): Compare triangle abc with area efcbd.
32. Until the mid-1970s local authorities had freedom to build (within unit costs limits). Thereafter public expenditure constraints on local authority borrowing and investment and on social housing grant for housing associations, so social investment no longer (if it ever was) at the margin. Instead financial constraints imply shortages. As a result no obvious mechanism for allocation and pricing (figure 7).

Example 6: Allocation

33. If prices < equilibrium, excess demand requires an administrative allocation process. Main possibilities include: first come, first served; allocation in relation to need; lottery (the last has never been used in the UK, but quite usual in some other countries). Waiting lists reflect the first, but problems of priority needs, given social sector last resort. Even within waiting lists normally prioritise, groups often through a points system reflecting professional assessment of relative need. Also problem of matching household type etc. with dwellings coming vacant.
34. Allocation in relation to need: how weight different needs – for a dwelling at all,

for a suitable dwelling etc. Categorisation of needy households, and the suitability of existing dwellings for these households. Problems of those excluded. Over last decades forms of point system within a waiting list system, together with varying legal requirements to house identified homeless families. Current policy aiming at introducing choice-based lettings (Marsh et al 2003, DCLG website).

Example 3: Pricing

35. Problem of how to price/set rent. Is price simply a tax, if individuals cannot choose? Is there any benefit in these circumstances of price/rent related to marginal cost?
36. Distinction between average rent levels, which are normally expected either to cover cost or to achieve a specified rate of return on capital, and rent structures, i.e. differentials between different types of property.
37. Rent levels are set in different ways between different finance systems. Local authority revenue funding based on deemed rents related to capital values. Traditionally involved large scale cross subsidy from older to newer limits. Housing association rents are mainly the result of grant rates (subject to cost efficiency). Current pressures on grant rates are resulting in cross subsidy between existing stock and new developments.
38. Rent structures can in principle be set in relation to:
 - i) the market, i.e. private sector rents or rates of return on capital values, reflecting short-run consumer valuation;
 - ii) costs of production, either historic (with little efficiency basis) or current cost reflecting direct opportunity cost and, depending on cost measurements, long-run original cost;
 - iii) tenant attributes including household structure, income etc;
 - iv) relative valuation of dwelling attributes, reflecting either individual preferences or professional valuation of needs.
39. (i) and (ii) would reduce to long run equilibrium rents if rate of return set equal to relevant opportunity cost of capital and investment adjustment were permitted. In an administrative system where full adjustment is not permitted choice is limited, there are always information problems, and the problem of allocating scarce resources remains.
40. Over the last decades there has been very limited pressure on local authorities to relate individual rents to either consumer valuations or costs through e.g. competition with market provision. However, some evidence of market pressure on housing associations. The legal framework requires that dwelling rents are set without respect to individuals' household circumstances). Since 2002 the

government has reintroduced rent controls on individual properties via a capital value/local income based formula (Solomou *et al*, 2004, Dataspring website) which aims to generate consistency by 2012.

III Overall Conclusions

41. Fundamental requirement is that people are housed decently. Mechanisms for ensuring that identified needs are met: through market plus individual subsidies; via direct responsibilities of local authorities; via managing the existing stock including transfers from social to private etc – via local authority enabling; and via subsidy related to responsibility to house among independent social landlords: HAG, special grants etc. Current system both still extremely constrained and responding to very different financial and incentive regimes. Local authorities directly controlled; limited (although currently increasing) capital funding to associations; private rented sector still disadvantaged; and benefit system unsustainable in existing form.
42. Current system still extremely constrained. Each tenure is also responding to very different financial and incentive regimes. Local authorities directly constrained; limited capital funding to associations; private rented sector still disadvantaged; and benefit system unsustainable in existing form.

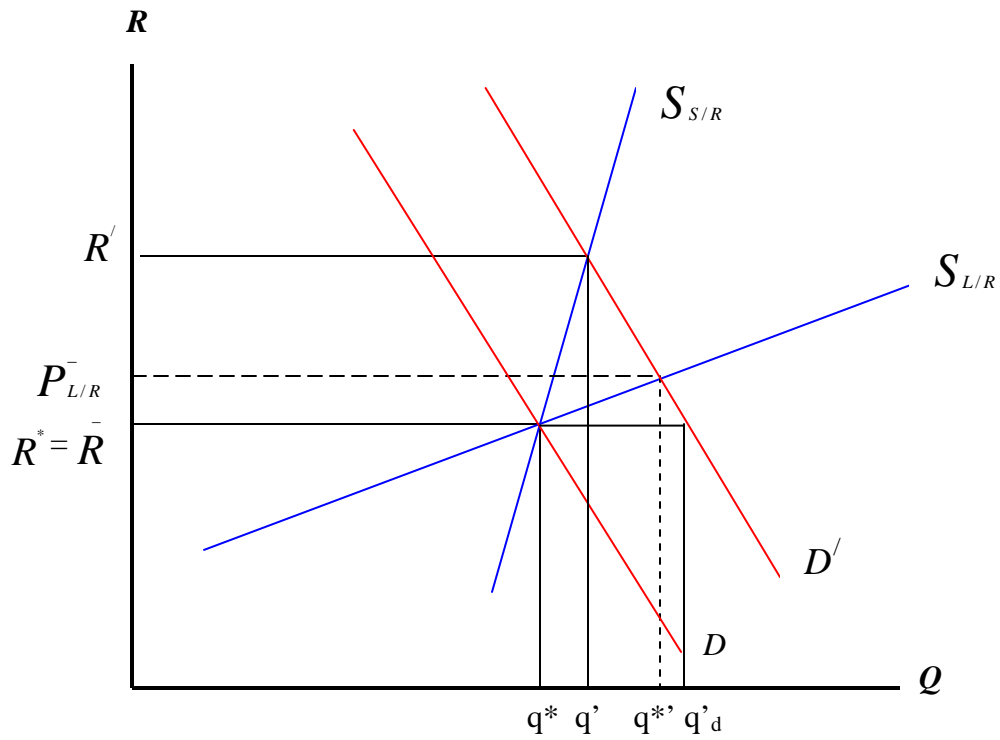


FIGURE 1 : EFFECT OF RENT CONTROL

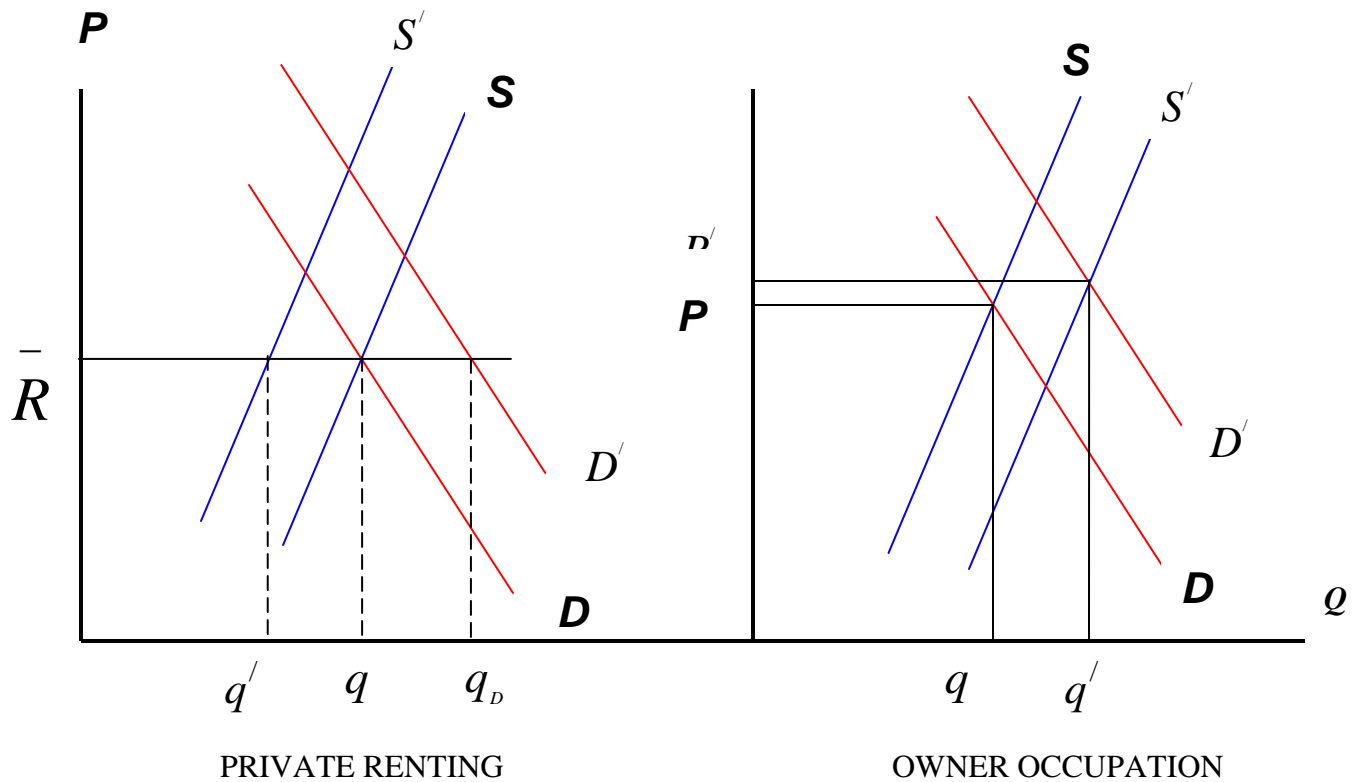


FIGURE 2: RENT CONTROL: TRANSFER of PROPERTY BETWEEN TENURES

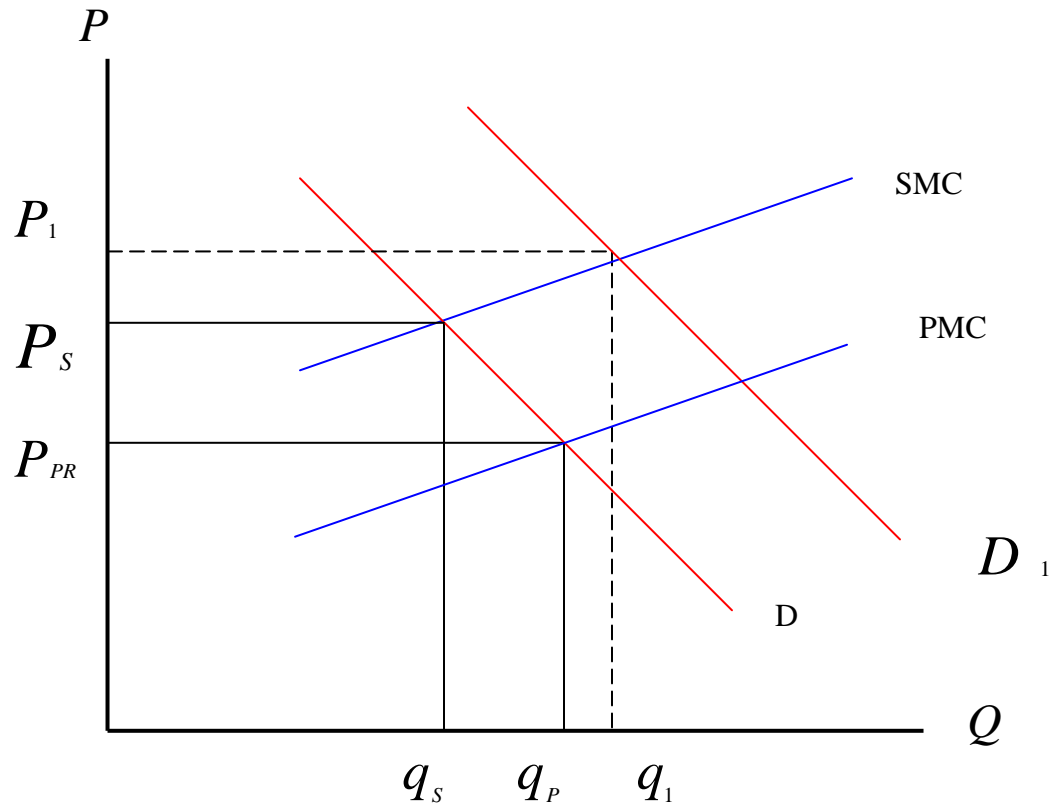
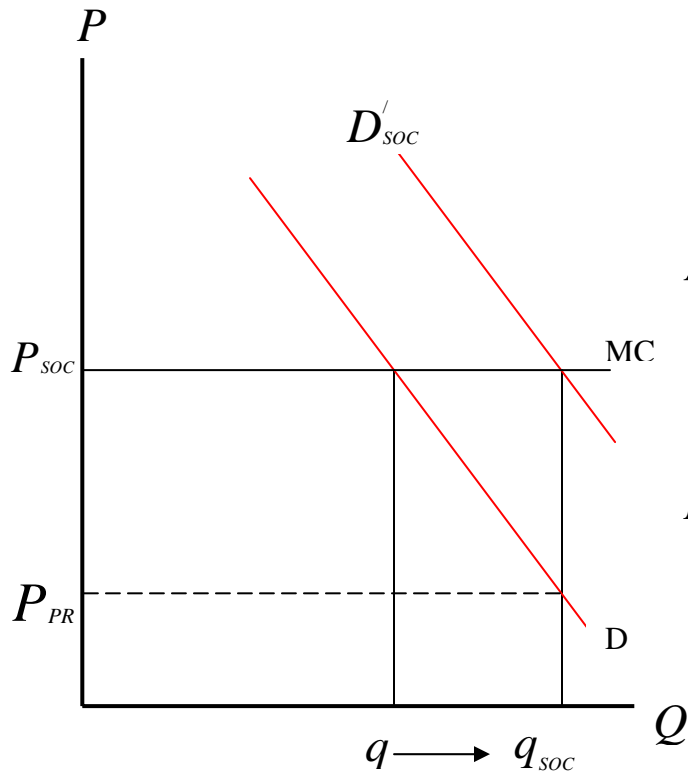
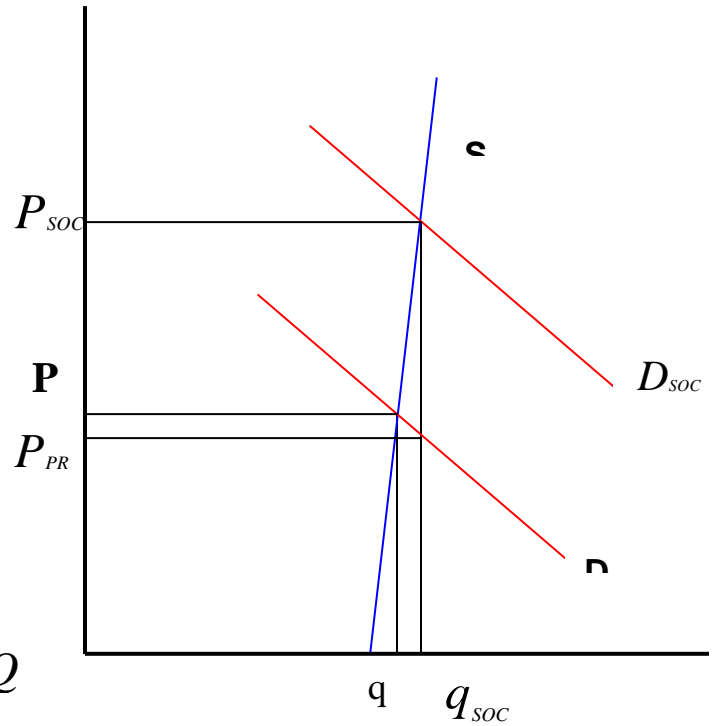


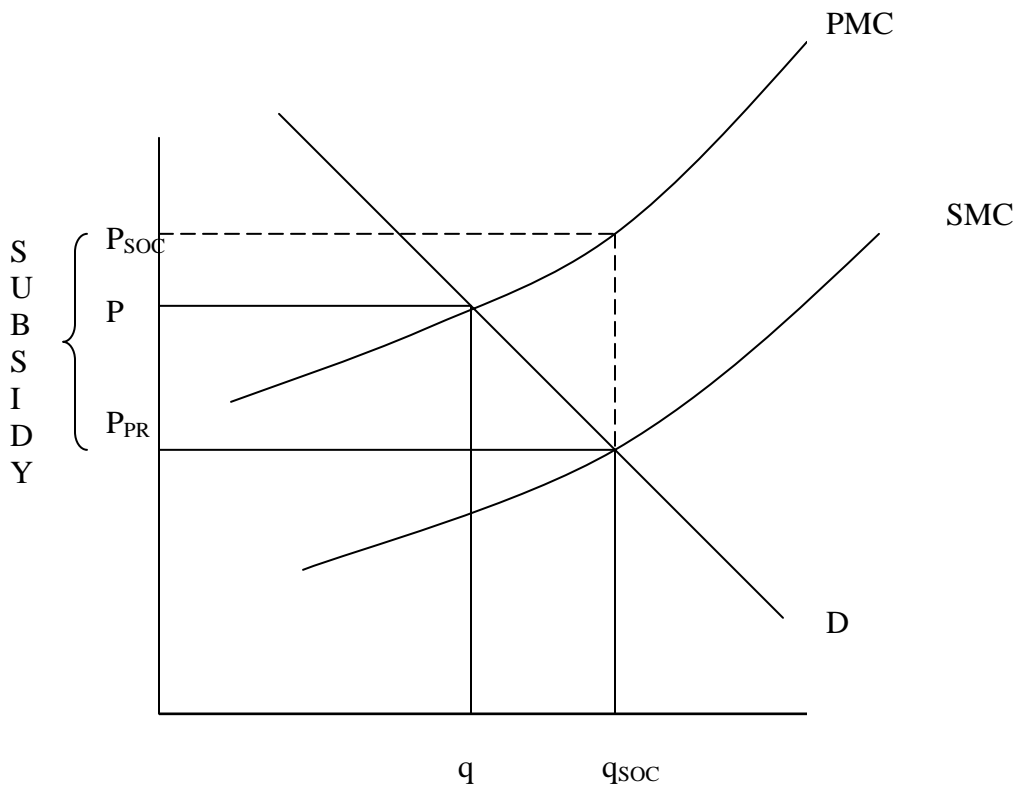
FIGURE 3: FITNESS STANDARDS



(a) demand subsidy - elastic supply



(b) demand subsidy – inelastic supply



(c) Supply Subsidy

FIGURE 4: IMPACT OF SUBSIDIES

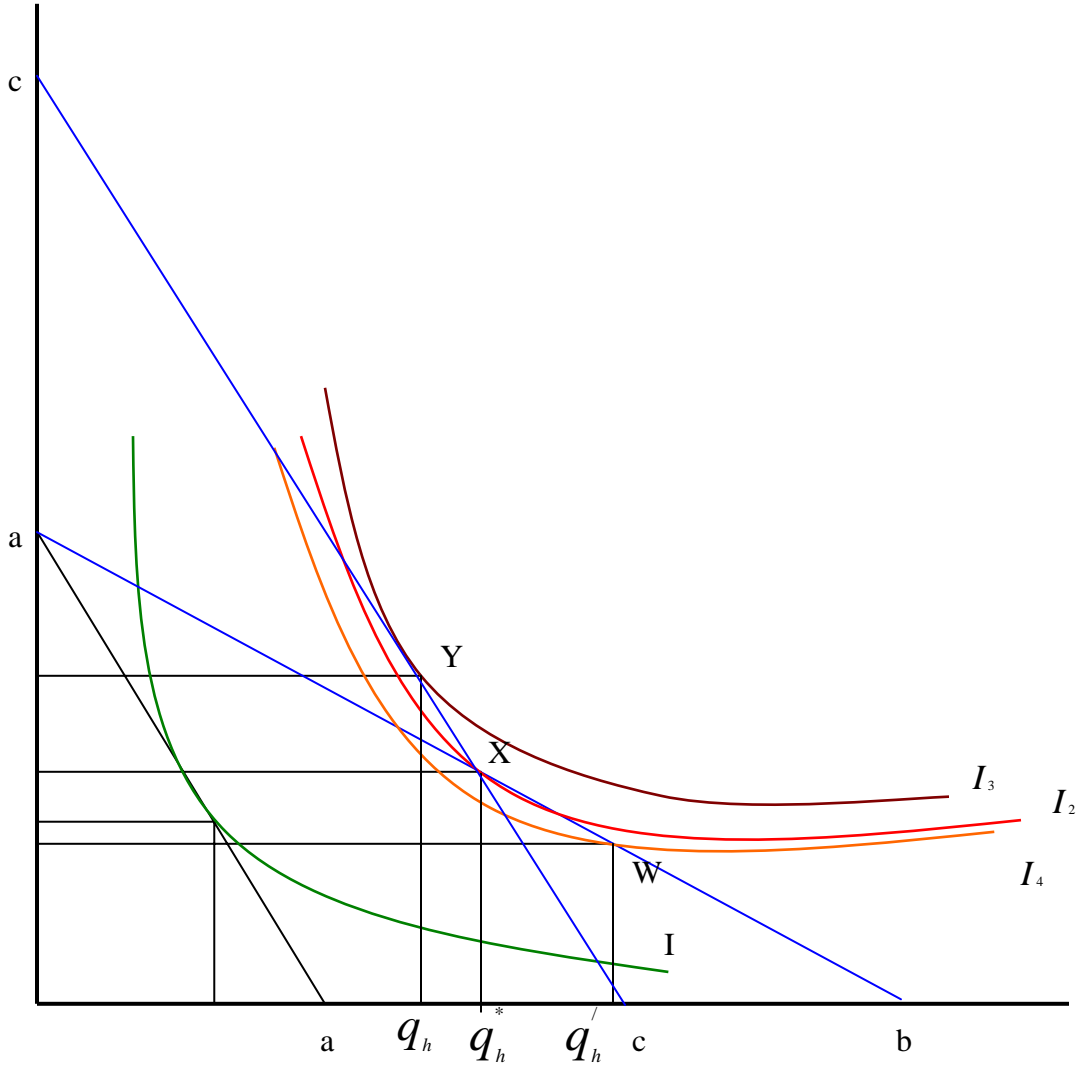


FIGURE 5: INCOME VS PRICE SUBSIDIES

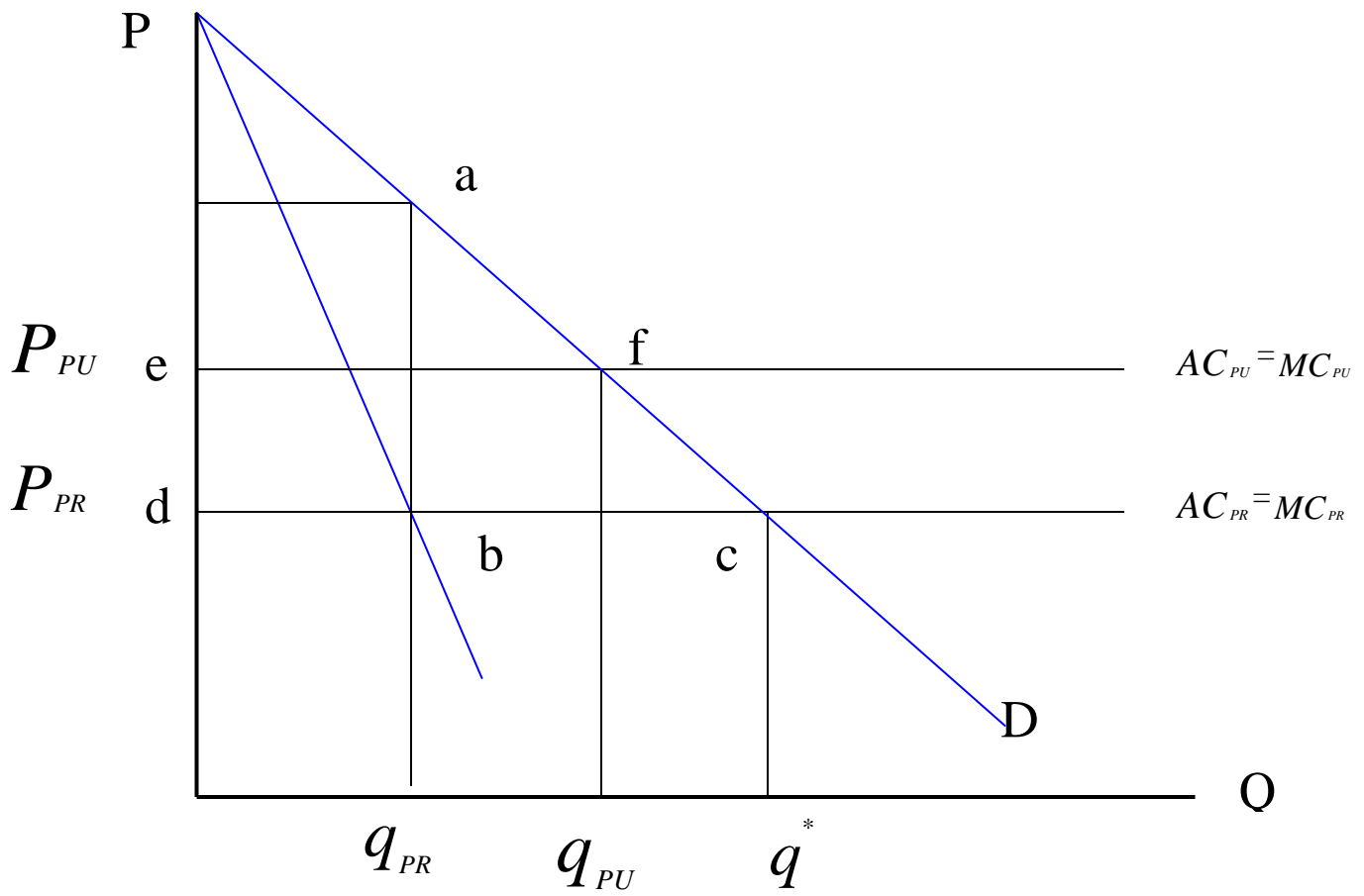


FIGURE 6: ALLOCATIVE Vs PRODUCTIVE EFFICIENCY

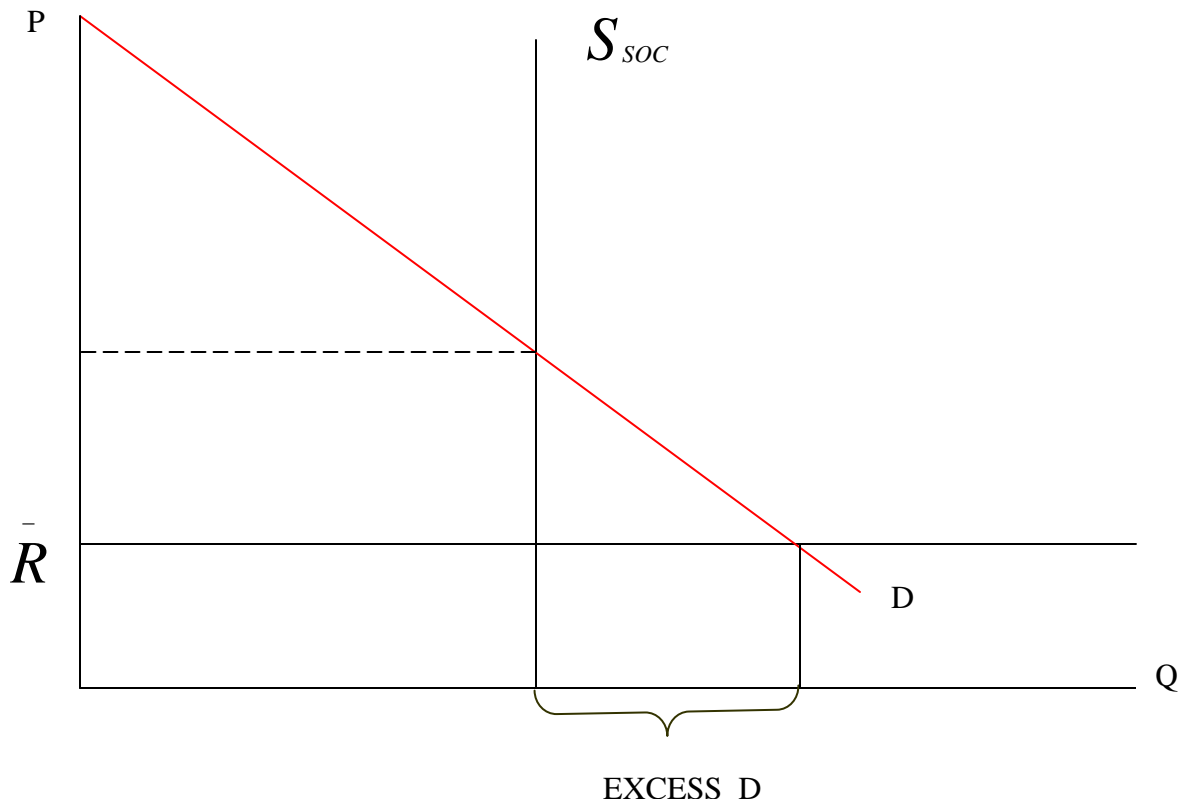


FIGURE 7: CONSTRAINED OUTPUT WITH CONTROLLED PRICE