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# DREAMS AND REALITY?

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Government finance, taxation and the private  
housing market

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## Executive summary

Both the coalition and the current governments have undertaken widespread intervention in the housing market. Whereas previously such involvement was mainly through the tax system or aimed at delivering more affordable housing, a wide range of financial and other incentives have now been put in place to stimulate homeownership or the housing market generally, building on measures that began four decades ago but are now on an unprecedented scale. Although individual initiatives such as Help to Buy have been examined by researchers, there has been little or no assessment of government intervention in the round. This report aims to fill that gap.

### Scope of the report

- It brings together the evidence of the overall scale of government involvement in the housing market through a detailed examination of the range of spending, taxation and related measures that the government employs, primarily from 1980 onwards.
- It highlights the growing involvement of government in the market and its interventions in both homeownership and private renting. To provide context, it also briefly describes interventions relating to social housing.

### The market context

- The housing market has undergone substantial change and this is reflected in changing household characteristics, with fewer younger households in homeownership, and an increased number of families with children in the private rented sector. Homeownership among older age groups has never been greater, with retired households owning substantial aggregate housing wealth.
- Short and medium-term aspirations to homeownership are little diminished, and remain well above the levels actually being achieved.

### Direct government support

- In terms of housing policy, the reliance upon market provision has increased but the market itself has become increasingly controlled and influenced by government and allied institutions. This has consequences for house prices, rents and affordability and for overall exposure to market cycles.
- Currently governments across the UK are providing direct support of the order of £37 billion over the five years to 2020/21 for homeownership and private renting, through a combination of loans, grants and guarantees – around £8 billion per annum. However less than a third of that funding is outright grant, and (depending on the extent of any losses on loans and guarantees) outturn government expenditure is likely to be much lower.
- Over half of government support is specific to homeownership, and two-fifths is to more broadly support private sector housing supply.

- In addition housing benefit expenditure on the private rented sector is now very significant, running at almost £8.5 billion per annum. Government cuts in eligibility have slowed the growth of this figure, but concerns remain, adding to wider pressures to control rent increases and more generally enhance regulation of the sector.
- The government safety net for homeowners has been much reduced since the downturn and support for mortgage interest will soon migrate from paying mortgage interest charges for unemployed home buyers to providing loans – a further erosion. In future, this may be offset to a limited degree by the protection offered by mortgage regulation and macro-prudential controls, but these will not mitigate the difficulties arising from unforeseen changes in household circumstances.
- Taking all the above direct support measures into account, we see that overall support for private housing across the UK amounts to some £83 billion over the five years to 2020/21.
- Over the same period, support for social housing and social housing tenants runs at around £20 billion per annum, of which roughly three-quarters relates to housing benefit payments.

#### **Taxation and tax reliefs**

- Taxation and tax reliefs are also a major component of the relationship between government and the private market. Historically, homeowners benefitted from the abolition of Schedule A tax in 1963 (a tax on the imputed rental income of their home) but then saw the demise of mortgage interest tax relief (MITR) in 2000.
- For private landlords, taxes apply net of operating costs – including mortgage interest. In broad terms it is estimated that the total tax yield from the sector is about £8 billion (based on income tax, corporation tax and capital gains tax).
- For landlords the tax landscape has changed greatly following the 2015 Budget. Going forward (on a phased basis) tax relief on mortgage interest costs will only be claimable at basic rate of tax and other tax benefits have been reduced. The outcome is a substantially higher tax bill unless the landlord becomes a limited company. Clearly the impact of all these changes will depend on the exposure of individual landlords and their tax position. It is likely to result in a long-term reshaping of the sector.
- Council tax remains an important liability for households in all tenures. However this tax is both regressive – the lowest bands pay more on a relative basis – and out of line with current values as the valuation basis has not been updated since 1993 in England and Scotland (though Wales revalued in 2003 and added a ninth band).
- Capital gains tax is an area where homeowners are clearly advantaged over landlords. There is no CGT liability on the primary residence – a relief currently worth nearly £30 billion on an annual basis in gross terms. CGT statistics suggest that the value of disposals of residential land and buildings was around £15 billion in 2013/14 and the CGT levied was £4.5 billion. Landlord disposals will be part of this.

- Stamp duty (SDLT) now raises nearly £9 billion on an annual basis and this is despite lower transactions, thus highlighting the impact of higher rates imposed in the 2015 Budget. Though welcome reforms have been introduced, SDLT (and its equivalent Land and Buildings Transaction Tax – LBTT – in Scotland) continues to represent a material cost for buyers of average homes and has become more significant to buyers of higher-priced homes. The November 2017 Budget reforms also benefit first-time buyers, especially compared to buy to let investors.
- Inheritance tax has also been subject to significant change in recent years, making it easier for households to pass on housing wealth and including a complex relief for downsizing.
- Overall the tax arrangements have long favoured established homeowners over both private landlords; they do so even more following the recent changes to SDLT and the limits on mortgage interest tax relief for private landlords.

### **Market regulation**

- Though the private rented sector (PRS) is now subject to tighter controls on mortgages, landlords still benefit from having unrestrained access to interest-only mortgages.
- The oft forgotten but significant swathe of regulatory controls faced by homeowners has been added to in recent years through the regulation of the mortgage market by the FCA and subsequently the Financial Policy Committee. In addition capital controls and buffers, and the Bank of England's term funding scheme, have all added a complexity to this market.

### **Conclusions: context and comment**

- Affordability constraints on homeownership (outside London) are often exaggerated.
- Deposit requirements remain a major constraint, notwithstanding Help to Buy, SDLT reforms and related policies.
- In terms of comparisons between tenures, owners are net beneficiaries of government support compared with tenants, and social housing tenants benefit more than private tenants.
- A very crude estimate suggests that homeownership is the most 'subsidised' tenure, followed by social housing and then the private rented sector.
- Government has now made a significant investment in the private housing market and as a result is exposed to substantial house-price risk.
- It remains to be seen how far the swathe of recent reforms favouring first-time buyers in particular will moderate, or even reverse, the decline in the homeowner sector.
- Similarly the PRS looks set to continue to grow; the extent of that growth must also be expected to moderate after recent tax changes.

- In the long term, the PRS's continuing growth will impose a significant burden on government in the form of housing benefit costs for an increasing number of retired households that rent privately.
- Despite recent reforms there remain aspects of current policies, taxation and regulatory arrangements that serve, in different ways, as barriers to household aspirations to homeownership.
- There is a strong case for fundamental tax reforms to more directly relate them to property values and capital gains, along the lines advocated by the Mirrlees Review.
- There is also a case for reviewing the targeting and effectiveness of current policies to overcome the 'deposit gap' and to boost the supply of new housing; and to consider whether different policy measures might be more effective than current ones.
- Any review should give greater attention to the imbalances between established homeowners and younger households seeking to enter the owner-occupied sector, as well as to the differential policy effects between sectors.

The report aims to be UK-wide, but analysis and statistics are in some cases restricted to Great Britain or England because of the availability of data. Many of the tables and statistics are drawn from editions of the *UK Housing Review*, published by CIH, and when this is the case only the title of the *Review* is given.

The work on which this report is based was generously funded by UK Finance, the trade association for the finance and banking industry operating in the UK. The research and the views expressed are, however, the responsibility of the authors, Steve Wilcox and Peter Williams.

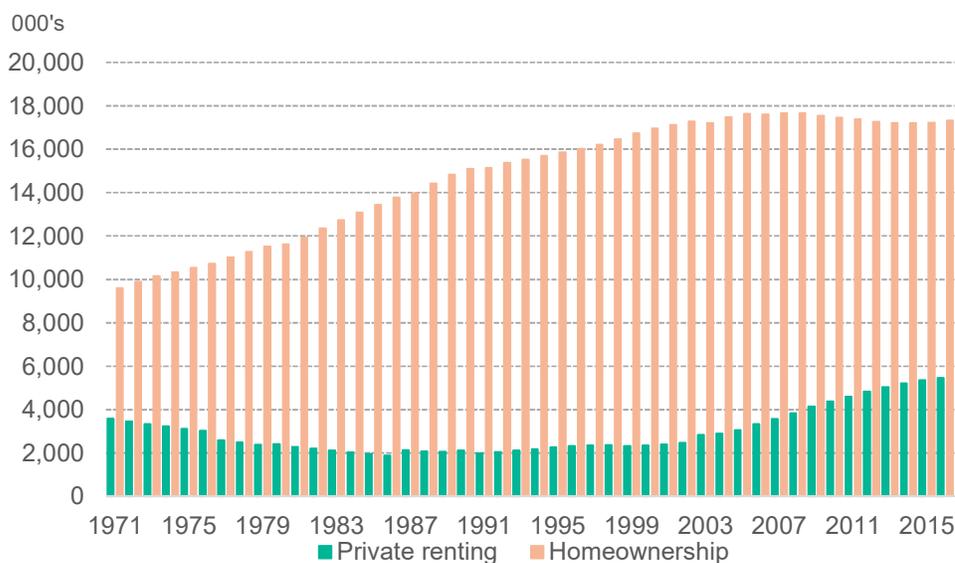
The Chartered Institute of Housing was invited to publish the report and does so to complement its work on *Rethinking Social Housing*, which has urged the government (among other recommendations) to review the whole range of its market interventions and focus them more strongly on the supply of more affordable housing to rent.

# 1 Introduction

## Housing market context

Major changes in the housing market have taken place over the last four decades and in large measure they have been brought about or underpinned by various forms of government intervention. The most obvious changes have been the rise, and then retrenchment, of the homeownership sector, and then the resurgence after 1990 of the private rented sector (Figure 1).

**Figure 1: Homeownership and private renting in Great Britain, by number of dwellings (000s), 1971-2016**



Source: DCLG.

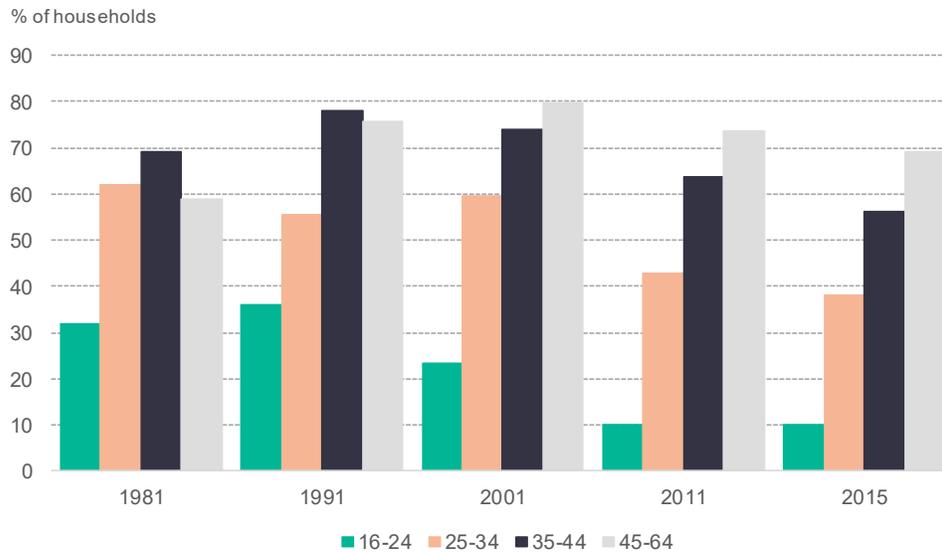
Within the wider trends we have seen a decline in the numbers of younger households in the homeownership sector, and an increase in the numbers of families with children in the private rented sector. The sharp decline in the numbers of younger households in homeownership is particularly notable. While in 1991 over a third of all very young households (aged 16-24) were homeowners, in more recent years the proportion has fallen to just one in ten. For moderately young households (aged 25-34) the proportion in homeownership has fallen from some two-thirds in 1991 to less than two-fifths in 2015.<sup>1</sup>

There has been a corresponding rise in the proportion of younger households in the private rented sector, as opposed to other tenures, from 43% at the beginning of the century to 64% by 2015. At

<sup>1</sup> See Resolution Foundation (2017) *Home Affront: housing across the generations*. London: Resolution Foundation.

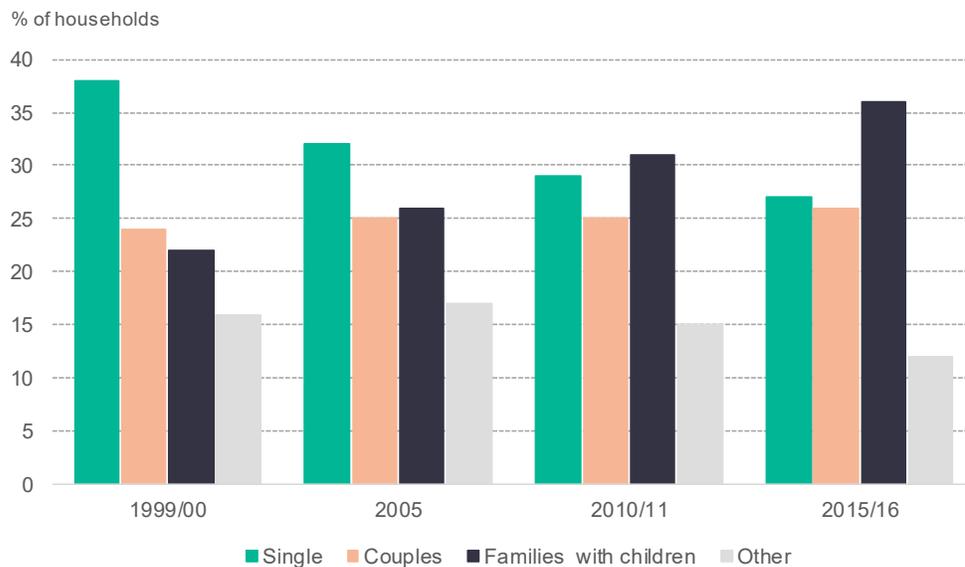
the same time, due to the substantial growth of the PRS, younger households nonetheless now make up a smaller proportion of all the households in the sector. While those aged under 35 formed 70% of all households in the sector at the beginning of the century, this fell to just 44% in 2015. Put another way, while only 30% of households in the private rented sector at the beginning of the century were aged 35 or over, by 2015 this proportion had risen to 56%.

**Figure 2: Homeownership by age of head of household in England, 1981 to 2015**



Source: English Housing Survey.

**Figure 3: Families with children in the private rented sector in England, 1999/00 to 2015/16**

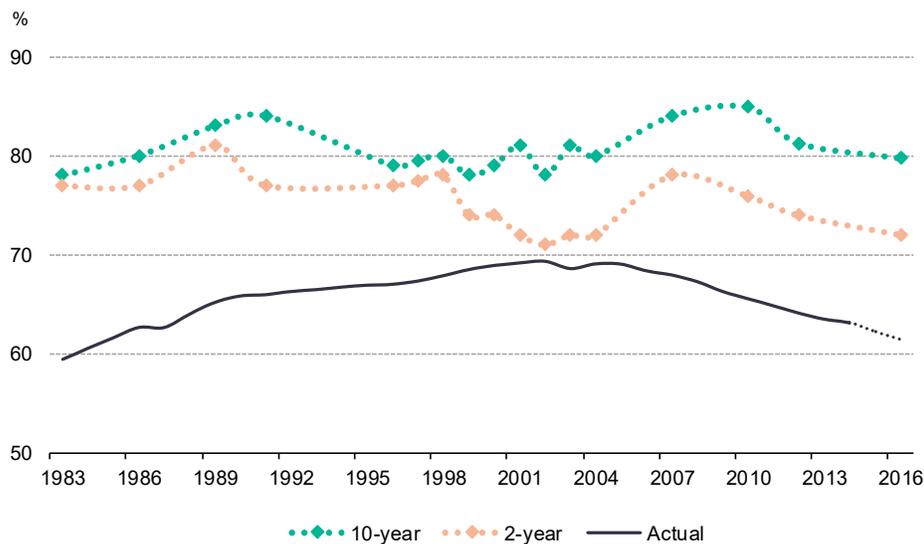


Source: English Housing Survey.

However, perhaps the more notable change in the private rented sector has been the growth in the proportion of families with children now living in the sector. From just over a fifth of all households at the beginning of the century, the proportion of families with children has risen to well over a third (36%), as shown in Figure 3 above. The greater proportion of that rise relates to couples with children, and altogether there are now almost 1.6 million families living in the PRS in England alone.

Notable as the changes are, the key questions are how far they simply represent household choices in response to the greater availability of private rented dwellings, and how far they are driven by features of the current housing market. There is no doubt that on the one hand the growth of the PRS has provided more flexibility and choice for households, while on the other it has reduced the stock available for purchase by homeowners. In the long run the great majority of households still aspire to ownership, and there is a substantial divergence between levels of achieved homeownership and aspirations to enter the sector (Figure 4). The clear inference is that there are many households in the PRS that are currently frustrated by their inability to become homeowners. However, the latest English Housing Survey shows that in 2015-16, 52% of all private renters *expected* to be owner-occupiers in the long term.

**Figure 4: Homeownership preferences: % of households preferring homeownership in two and ten years' time**



Source: UK Finance.

The extent of the frustration is perhaps best measured by comparing household aspirations to the proportions of households newly entering homeownership. As the data show, these are far lower than the average levels for existing homeowners which include previous cohorts of entrants in easier times that soften the impact of more recent constraints on the average position. Thus in 2015 just 44% of households aged under 45 were homeowners (in England) compared to the 70+% that would prefer to be homeowners within two years. If aspirations towards ownership remain far higher than their achievement this raises questions about the constraints that lead to this. We return to the issue in the final chapter.

## **Purpose and structure of the report**

The report's purpose is to set out the range of government financial and related interventions that have supported and helped to shape the trends just described. It covers their impact on the ways in which the housing market operates, and the changes in the characteristics of the households and dwellings in the housing market over the last four decades. From that platform the report will then briefly consider the future prospects for the housing market, and government policy options for the years ahead.

The forms of government financial intervention are diverse, and include measures of mortgage market regulation (and deregulation), measures of taxation (and tax reliefs), capital grants and revenue subsidies (for various purposes), and a wide range of specific housing and welfare policies, of which the right to buy is perhaps the most obvious and most significant. While this report will attempt to draw out the key characteristics and impacts of each of these measures, clearly there will not be the space to examine each one in all its glory – but references will indicate where fuller accounts can be found. It should be noted that there are inherent difficulties in trying to bring all of this together – this partly explains why it is rarely done! There are considerable data limitations together with the complex intertwining of spending and impacts which reach out far beyond the housing market. Our primary focus here is on the private housing market – this is the least closely examined – but we include a small section on social housing which is both an important part of the overall market and a long-term recipient of government intervention and expenditure.

The following sections of this report will examine each of the individual measures in turn, starting with direct government interventions as part of both housing and welfare policies, and including a section on government support for the social housing sector.

The report then turns to the taxation arrangements related to private housing, in the sense of both the taxes levied on private housing and the tax reliefs that are applied to the sector.

This is followed by an outline of measures of mortgage market regulation and deregulation, before moving on to a summary of the key changes to the housing market that have flowed from all these policy, taxation and regulatory measures, and the impact of those changes on the composition of households in the private sector.

In the main the report will cover the operation and impact of policy, taxation and regulatory measures over the years from 1980, while focusing primarily on recent changes and current provisions. Brief reference will also be made where appropriate to measures prior to 1980, not least to set the scene for the changes introduced from 1980 onwards.

The concluding section reflects on the total government contribution to housing and how this has changed over time, and how the balance between different tenures has changed. It considers the prospects for the private housing sector in the current economic and policy context, and this leads into an examination of some of the tensions and challenges inherent in current government policies and their objectives. This inevitably leads into a final discussion of the broad scope of policy reform that could permit the private housing sector to operate more effectively.

## 2 Direct government support

### Housing policies

Policy interventions are the most obvious manifestations of the relationship between government and housing, though as this report makes clear there is much more besides housing policy that connects the two. Indeed the scale of intervention in both the homeownership and private rented market is now very considerable and certainly much greater than it has been in the past, taking account of financial as well as non-financial instruments and regulations. Thus, as reliance upon the market in terms of actual provision of housing has grown, so the market itself has become increasingly controlled and influenced by government and allied institutions.

This in turn has had consequences for house prices, rents and affordability. Though there will always be arguments as to the precise impact of different measures, in practice we have seen a number of demand-side initiatives which have not been fully matched in volume by measures on the supply side (albeit that creating effective demand is in itself a requirement to bring forward a supply-side response). On balance, as many commentators concur, most government measures have pushed up prices and rents - although we would argue that this is to a modest degree. At the same time these measures have assisted some would-be owners to enter the housing market and we have seen a stabilisation of builders and mortgage lenders and a recovery in housing supply since the 2007/08 downturn.

### Policy – a brief summary

For the homeownership market the most obvious current housing-related policy components are these:

- Help to Buy: Equity Loans (and Forces Help to Buy)
- Help to Buy: Shared ownership
- Help to Buy: ISA/Lifetime ISA
- Right to buy/right to acquire
- HOLD/OPSO (for disabled/older people)
- Home improvement grants
- Home Building Fund (also private rented sector)
- Custom Build Serviced Plots Loan Fund
- Starter homes.

In terms of the private rented sector the elements are:

- Private rented sector housing guarantee scheme
- Home Building Fund
- Rogue landlords scheme funding
- Housing benefit
- Lettings agent fees.

The level of financial support being provided by the government for the private housing sector is indicated, programme by programme, in Table 1. The figures shown take account of the changes announced in the 2017 Autumn Budget. Support for the social housing sector is set out further below.

**Table 1 Government support for private housing in England 2016/17 to 2020/21**  
**£ million**

Programme	Period	Grant	Loan	Guarantee
Housing Infrastructure Fund <sup>1</sup>	2017/18 – 20/21	3,100		
Land Assembly Fund <sup>1</sup>	2019/20 – 20/21	485		
Small sites infrastructure etc.	2018/19 – 20/21	630		
Accelerated construction	2017/18 – 20/21	588		
Right to buy – extended pilot	2017/18 – 20/21	200		
Starter homes <sup>2</sup>	2016/17 – 20/21	369		
Help to Buy: Equity loans <sup>3</sup>	2016/17 – 20/21		9,300	
Help to Buy: Equity loans <sup>4</sup>	2017/18 – 20/21		10,000	
Help to Buy: Mortgage guarantee <sup>5</sup>	Apr 2016 – June 2017			623
Help to Buy: ISA <sup>6</sup>	2015/16 – 20/21	900		
Lifetime ISA <sup>6</sup>	2017/18 onwards	1,200		
Rent to Buy	2015/16 – 20/21	200	200	
Private sector guarantees	2017/18 – 20/21			8,000
Estate regeneration	2016/17 – 20/21	32	170	
Home Building Fund	2016/17 – 20/21		3,000	
Locally led Garden Cities	2017/18 – 18/19	29		
Ebbsfleet Development	2016/17 – 20/21	275		
Land Release Fund	2017/18 onwards	45		
<b>Total<sup>7</sup></b>	<b>2016/17 – 20/21</b>	<b>8,053</b>	<b>22,670</b>	<b>8,623</b>

Source: *UK Housing Review 2018*, Table 2.4.1 (with author adjustments).

Notes:

1. Following the 2017 Autumn Budget these funds will run to 2022/23, with further grants of £1,325 million and £525 million respectively in the years beyond 2020/21.
2. This budget was cut in the 2017 Autumn Budget.
3. This scheme ran from 2013/14; with £3.6 billion committed prior to April 2016.
4. Supplementary budget for extended scheme announced in October 2017.
5. Table includes only expenditure from April 2016, Scheme ran from October 2013.
6. Due to the slow initial take up for these ISAs the Office for Budget Responsibility has suggested that outturn expenditure will be much lower for both schemes. The table is based on OBR forecasts.
7. This table does not include the value of right to buy discounts, SMI or housing benefit for the PRS; each of these is discussed below. Nor does it include funding for private sector repair and improvement grants, as while these have been significant in the past, they are now negligible (see *UK Housing Review 2018*, Table 28).

The table shows that private renting and affordable homeownership are being funded and supported to a level of almost £39 billion over the five years to 2020/21. Of this, about 60% exclusively relates to homeownership, with approximately £3.5 billion specifically provided to support investment in the PRS. The balance is in a number of programmes to support private sector housing supply

generally, whether via ownership or renting. In addition to these programmes, which in many cases only cover England, the devolved administrations all run their own programmes to stimulate the private market, albeit on more modest scales.

In addition, account must be taken of the expenditure on housing benefit for private sector tenancies over the same period of £44.5 billion, and support for mortgage interest at £544 million for the two years before it is replaced by loans for mortgage interest (LMI).<sup>2</sup> Together with the £39 billion identified above, this amounts to a total level of expenditure and support for private housing in the UK as a whole of some £84 billion for the period, or an average of some £16.8 billion a year.

Notwithstanding the scale of this support, we have seen a decline in the proportion of households in homeownership albeit that absolute numbers have stabilised since 2013.<sup>3</sup> Measured by the number of owner-occupied homes, homeownership in the UK fell from a peak of 18.18 million in 2008 to 17.83 in 2016 with the proportion dropping from 69% in 2005 to 62.6% in 2016.<sup>4</sup>

However (welfare benefits aside) over three-quarters of the support to private housing is in the form of either loans or guarantees, and the outturn expenditure costs to government of that support are likely to be very considerably lower. The Help to Buy mortgage guarantee and equity loan schemes are good cases in point. In the former scheme (which ran from October 2013 until it was closed in June 2017) government offered a £12 billion loan guarantee fund for mortgage lenders to help kick-start higher loan-to-value (LTV) lending. Lenders paid a fee to use it (it had to be self-financing, as required under EU rules). It could be used on existing and new build homes, and allowed lenders to purchase a guarantee on loans where the borrower has a deposit of between 5% and 20%. However, many lenders did not use it, preferring to self-insure.

Altogether some 105,000 loans were completed with the support of the scheme, with guarantees covering £2.3 billion of loans against properties valued at £16.7 billion. Of the £2.3 billion total just £623 million fell in the period from April 2016. Although the scheme only ever used a fifth of its budget, it was still effective in helping re-open the higher LTV lending market.<sup>5</sup> Figure 5 below shows how the recovery of first-time buyer lending improved after the launch of the scheme. This market has continued to develop since the scheme closed.

Access for house purchasers with limited deposits has also been supported by the Help to Buy equity loan scheme, also launched in 2013 and now extended to 2021. It had a budgeted loan capacity of £12.9 billion though with the launch of Help to Buy equity loan London offering a 40% loan (as compared to 20% equity loans elsewhere) that capacity was being used up quite rapidly. Most recently the government has announced an additional £10 billion of funding for the scheme (effectively recycling the unused budget from the Help to Buy mortgage guarantee scheme).

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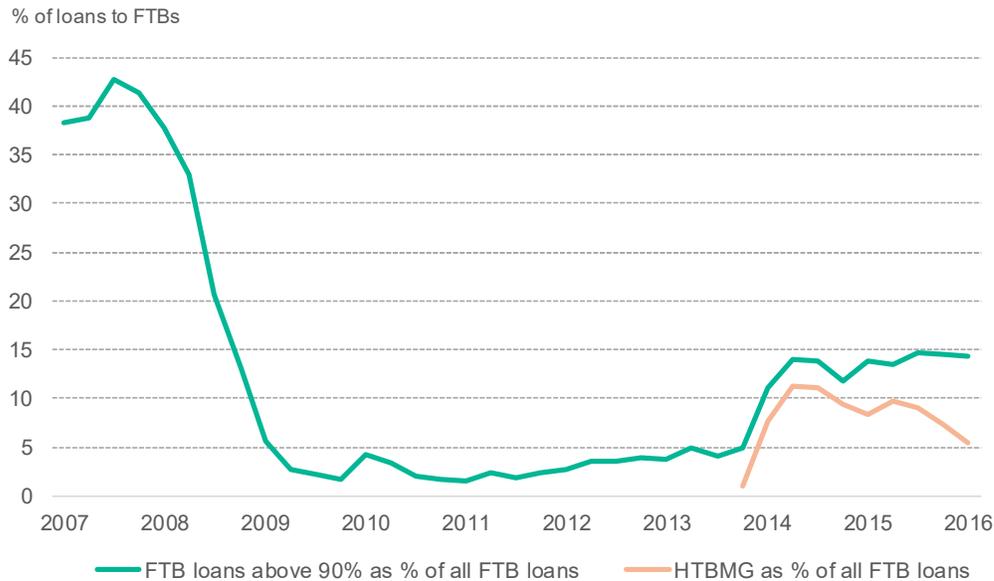
<sup>2</sup> At the same time it should be recognised that the cost of housing benefit for social sector tenants will amount to over £70 billion for the same period (*UK Housing Review 2018*, Table 113).

<sup>3</sup> The picture is very different across age cohorts and family types; see Resolution Foundation (2017) *Home Affront; housing across the generations*. London: Resolution Foundation.

<sup>4</sup> See *UK Housing Review 2018*, table 17.

<sup>5</sup> Jamei, M. (2016) *A government scheme that worked*, CML News, 17th August. London: CML.

**Figure 5: High LTV loans to first-time buyers 2007 to 2016**



Source: UK Finance calculations.

Note: LTV is loan-to-value; HTBMG is Help to Buy Mortgage guarantees.

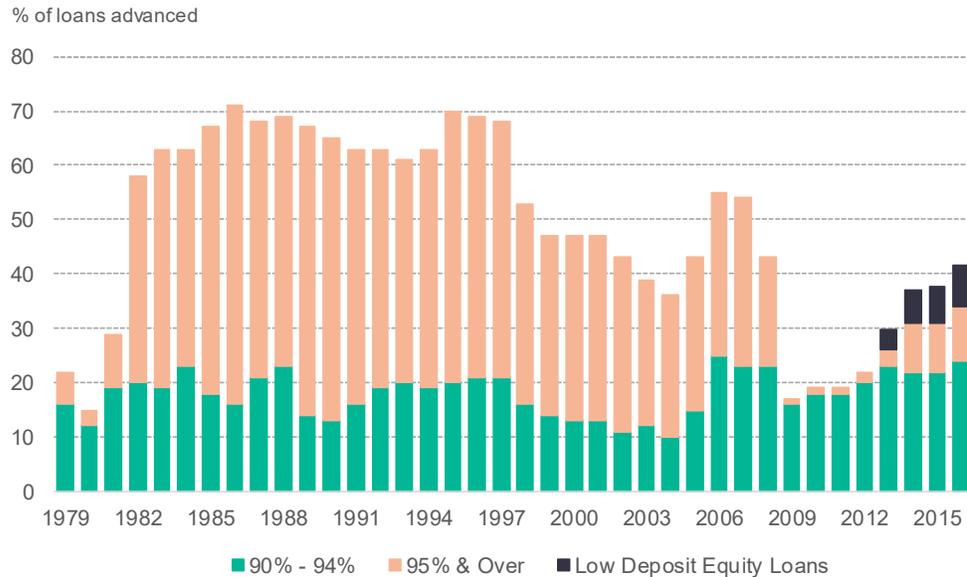
Over the period since the launch of Help to Buy equity loans, 169,102 properties have been bought with the support of the scheme (to March 2018), of which the majority were by first-time buyers (81% of total sales). Of those, some 79% of the equity loans enabled the purchasers to require deposits of no more than 10% of the total purchase price.

Taken together, mortgage guarantees and equity loans have gone a long way towards achieving a recovery in the overall ability of first-time buyers to undertake (new build) purchases with a low deposit, as shown in Figure 6 below. The incidence of mortgages requiring a low deposit in Figure 6 is higher than shown in Figure 5, as Figure 6 includes 90% *and above* loans, rather than *just over* 90% loans. To that is added the impact of equity loans, that top up conventional mortgages with much lower LTVs (most often 75%), so that together they leave buyers with a low deposit requirement.

The Help to Buy equity loan scheme not only assists buyers by reducing the deposit required, it also acts as a form of shared ownership, and enables households to purchase with just a 75% mortgage, thus making house purchase far more affordable. This is especially the case as for the first five years no payment is required against the equity loan, although payments kick-in thereafter typically adding close to 10% to the total payments buyers have to make after that period.<sup>6</sup>

<sup>6</sup> The precise uplift will depend on the interest rate on the mortgage, and the ratio between the amount covered by the mortgage and the amount of the equity loan. With, for example, a £40,000 equity loan and a 25-year repayment mortgage at 2.5%, the initial 1.75% interest payment on the equity loan after 5 years would add 8.6% to the total monthly repayments.

**Figure 6: Low-deposit mortgages for first-time buyers, 1989-2015**



Source: UK Finance.

Note: Low Deposit Equity Loans are those requiring a deposit of no more than 10%.

The NAO review of the scheme published in March 2014 observed that it was very difficult to assess the effective long-term costs of the scheme, or its net impact in bringing forward additional housing supply.<sup>7</sup> It also quoted the original DCLG central estimate of net costs of just under £500 million against an initial programme of £2.9 billion for 74,000 loans. While this central estimate put the net costs at around one-sixth of the initial investment, in alternative scenarios the costs estimates ranged from less than £20 million up to over £1.2 billion.

However the actual net costs (or even profits) will not be known until the scheme has fully run its course (the equity loans are for up to 25 years) and are heavily dependent on future house price movements. House prices over the period to April 2017 increased above the assumed rate in the DCLG estimate, and on that basis the scheme could even generate a net profit; but with the signs that prices are now easing in the face of Brexit-related economic uncertainty, that scenario could rapidly change. The loan book sits with Homes England at a current value of around £8.3 billion.<sup>8</sup> It is a contingent liability with the return to the government dependent upon the performance of the equity loans and house price movements over the period the loans operate.

Nonetheless it is clear that the scheme has had some market impact. This could hardly fail to be the case given its scale – being related, for example, to just over one-in-five of all new build completions in England in 2015/16 and 2016/17. However, as well as its potential impact in supporting some part of the increase in new build levels since its introduction, there are also questions about how far it

<sup>7</sup> <https://www.nao.org.uk/wp-content/uploads/2015/03/The-Help-to-Buy-equity-loan-scheme.pdf>

<sup>8</sup> Homes England (2018) HCA Annual Report & Financial Statements 2017-18, p.27.

might have affected new build house prices and how well the scheme is targeted. A 2017 report argued that new build house prices are now much higher relative to prices for second-hand dwellings following the introduction of Help to Buy equity loans.<sup>9</sup> However, revised year-end house price figures for 2017 suggest that the price effect is more limited, and that while the ratio of new-to-old house prices has increased post-2010, it remains slightly below the average for 1995-2007. Nonetheless the lower level of potential prices on the resale of dwellings initially purchased with an equity loan is another factor that will slightly depress the value of the government's equity loan stake, and thus increase the potential outturn costs to government.

The costs involved in the Help to Buy ISA and the Lifetime ISA are in one sense a little easier to estimate, as they simply involve the government in making 25% matching contributions to the savings put into the schemes. Nonetheless any estimate of the future take-up of these schemes is at best somewhat heroic.

The Help to Buy ISA began in December 2015 and runs until November 2019 (government contributions can be claimed up to December 2030). The published statistics show that 146,753 property completions were assisted by this scheme up to the end of the first quarter of 2018 with total property value of £25.3 billion and the payment of £157 million of bonus payments.<sup>10</sup> However, the average unit costs under the scheme are modest, at about £800 over the period, against the purchase of dwellings with average values of just £172,448. Over a quarter of all purchases were in the northern regions of England, against less than a fifth in London and the South East and a fifth in Scotland, Wales and Northern Ireland.

Over time, average bonus costs can be expected to increase as savers will tend to have been in the scheme longer, thus attracting a higher bonus. More than one million people currently have a Help to Buy ISA,<sup>11</sup> and the maximum bonus that can be paid is £3,000 per saver (which would require savings of £12,000 or more). The numbers with such ISA accounts are not, however, likely to grow much further as the scheme has effectively been superseded by the more generous Lifetime ISA introduced in April 2017, which permits savings of up to £4,000 a year with no maximum limit on bonuses, and the purchase of higher-value dwellings.

If the long-term costs of the Help to Buy ISA are therefore likely to be higher, its impact on the housing market cannot yet be assessed as savings from the scheme can be released upon retirement as well as to support house purchase. The cost of the scheme over the five years to 2019/20 has been estimated at £1.7 billion, but over the longer term the combined costs of this and the Lifetime ISA scheme were in 2016 estimated by the Office for Budget Responsibility to rise to some £2 billion

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<sup>9</sup> Morgan Stanley (2017) *The 'Help to Buy premium' and its unintended consequences*. London: Morgan Stanley. Findings are based on the ONS mix-adjusted house-price series for sales of new and second-hand houses. However much of the increased premium found relates only to part of 2017, and these house-price series are typically subject to revision during the year. ONS data from April 2018 show that the average ratio of 'new to old' prices in 2017 was 124.1, up from 116.1 in 2010, but still lower than the 1995-2007 average of 124.4.

<sup>10</sup> HM Treasury (2018) *Help to Buy: ISA scheme Quarterly Statistics, Data from December 2015 to March 2018*. London: HM Treasury.

<sup>11</sup> See [www.ft.com/content/ab4a309a-8413-11e7-94e2-c5b903247afd](http://www.ft.com/content/ab4a309a-8413-11e7-94e2-c5b903247afd)

per annum;<sup>12</sup> however, subsequently the OBR indicated that because of the slow take up of both schemes they have significantly scaled down their estimated costs.<sup>13</sup>

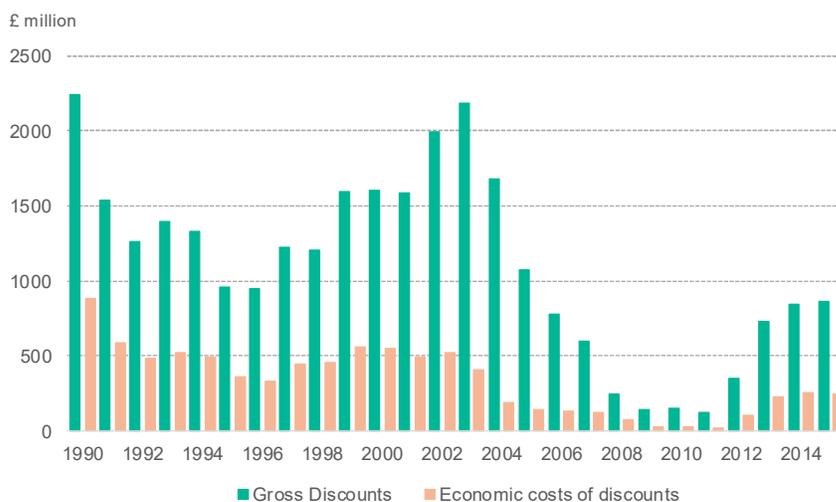
It is often argued that the Help to Buy mortgage guarantee, equity loan and ISA schemes are demand-side measures that have, at least to a degree, inflated house prices at the same time as permitting more households to access homeownership and aiding housebuilders to build more homes. However, as shown above, low-deposit mortgages (and especially ones requiring less than a 5% deposit) only remain available at levels that are some way below those that prevailed over the two and a half decades before the 2008 housing market collapse.

Three further factors also need to be recognised. The first is that creating effective demand is, in itself, a prerequisite for bringing forward market supply. The second is that much of the impact of Help to Buy has been to support demand switching from the PRS to the homeowner sector, rather than adding to overall demand in the private housing market. Third, and less positively, policies that boost first-time buyer demand for new homes weaken an already illiquid housing market by further reducing housing chains and making the buying of existing dwellings less attractive.

### Right to buy

One major policy related to homeownership not included in Table 1 is the right to buy (RTB), as this does not have any direct public expenditure costs. It does, however, have opportunity costs in the form of the disposal of state-owned assets at below market value.

**Figure 7: Right to buy discounts in the UK, 1990 to 2015**



Source: *UK Housing Review 2017*.

Notes: Economic costs are estimated as discounts above 32% of full open-market value. Data are for council house sales in England, Scotland and Wales. They do not include housing association sales.

<sup>12</sup> Johal, S., Matthews, P. & Taylor, D. (2016) *Fiscal sustainability analytical paper: Private pensions and savings: the long-term effect of recent policy measures*. London: Office for Budget Responsibility.

<sup>13</sup> Office for Budget Responsibility (2017) *Economic and Fiscal outlook, November 2017*, Cm 9530. London: OBR.

Gross discounts for council RTB sales in Great Britain, over the 26 years since 1990/91, have amounted to almost £29 billion (see Figure 7 above). Those sales, and especially the higher level they reached in the 1980s, were major contributors to the growth in homeownership to its peak level of 69% in 2005.

However, the gross discounts are calculated against open-market values, while RTB sales are made to sitting tenants with security of tenure for dwellings with sub-market rents. A value for money analysis of the RTB policy taking account of those and other related factors concluded that something like a 32% discount represented fair value to the state for such sitting-tenant sales.<sup>14</sup> Taking that into account still leaves a net opportunity cost of just over £8 billion for all the RTB sales over the period, and this can be viewed as a cost for promoting homeownership over social renting.

Both the Scottish and Welsh Governments have now abolished the right to buy, so any net opportunity costs (currently running at just over £300 million on around 18,000 sales per year) will only continue to be incurred in England.

### **Welfare and other policies to ameliorate market downturns**

The following brief commentary on the safety net for mortgage borrowers draws upon a UK Finance report *Challenges for our Homeownership Safety Net: UK and international perspectives*.<sup>15</sup> Our focus here is upon the role of government and its relevant expenditures. The safety net for mortgage borrowers is primarily focussed upon home buyers but we should not ignore how housing benefit for private tenants feeds through into support for landlord mortgage payments.

We can take both narrow and wide views of what constitutes the safety net for mortgage borrowers. A narrow definition would include support for mortgage interest payments (SMI), central and local government mortgage rescue schemes and the court structures around the treatment of arrears and possessions cases (set out more fully in the Appendix). A wider view would bring in conduct and prudential regulation of the mortgage market including the FCA's MCOB rules, the PRA prudential rules (or equivalent in the FCA) and the macro-prudential rules now in place via the Financial Policy Committee of the Bank of England (see Chapter 4).

As is evident from the Appendix, a number of the initiatives to combat mortgage arrears and possessions were put in place after the 2008 market downturn. As well as the mortgage rescue scheme this included changes to SMI – both substantially reducing the delay before it could be claimed and increasing the maximum level of mortgage that could be covered. The shorter delay before a claim was eventually made available until March 2016 (before reverting to the longer 39-week period), the higher maximum level of eligible mortgage continues to be available for both SMI and loans for mortgage interest (LMI – see below).

In terms of spending, the most obvious calls on the Exchequer from the narrow safety net are the costs of SMI and housing benefit for private landlords. The cost of SMI peaked at £563 million in

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<sup>14</sup> Wilcox, S. (2006) 'A financial evaluation of the right to buy', in *UK Housing Review 2006/2007*. Coventry: CIH.

<sup>15</sup> Williams, P., Wilcox, S. and Whitehead, C. (forthcoming), *Challenges for our Home Ownership Safety Net: UK and international perspectives*. London: UK Finance.

2009/10 (the previous peak was £1,016 million in 1995) then fell in subsequent years to £278 million in 2016/17 (and a forecast £266 million in 2017/18).

In 2018, SMI moves from being a grant to a loan and becomes loans for mortgage interest (LMI). This is seen by government as a fairer and more sustainable form of support. The loans will accrue interest based on the cost of gilts (forecast to be 1.5% when the SMI loan scheme commences), and recovery will not be pursued until the property is sold or transferred.<sup>16</sup>

As the impact assessment published in July 2015 makes clear, 'the proposed policy is to change SMI from a benefit into a loan and to maintain the increase in the SMI limit on mortgage capital at £200,000 for working age claimants, a level to which it was increased as a temporary measure in January 2009. This is intended to make the system fairer to the taxpayer, whilst maintaining support for homeowners who need it'.<sup>17</sup> The impact assessment says that 'by 2018/19 the cost of SMI is projected to be £250 million' and then goes on to forecast savings over the first three years of the switch to LMI of just over £750 million.

In addition to SMI, currently homeowners can access in-work tax credits which are important given the absence of in-work benefits to assist homeowners with their mortgage costs. Tax credits provide a partial cushion for homeowners who suffer a substantial drop in their incomes from employment, such as when one partner loses his or her job while the other remains in work. At current rates it would enable a couple with children to cover a mortgage of some £120,000 while leaving them with a disposable income above the levels of baseline welfare benefits such as JSA and income support. This is broadly in line with the average level of outstanding mortgages.

However, with the roll-out of universal credit (UC) planned to be completed by 2022, the tax credit regime will come to an end. Under the new scheme the SMI and subsequently LMI element will only be available to those claimants entirely out of work. LMI will also continue to be available to pensioners in receipt of pension credit, though of course by then it will be a loan rather than a grant.

The DCLG launched the two-year mortgage rescue scheme in January 2009 with a budget of £205 million from the National Affordable Housing Programme, administered by the (then) Homes and Communities Agency (the Agency). In April 2009 it added a further £80 million. In October 2010 DCLG was allocated a further £221 million to continue the scheme until spring 2013. The numbers going through the scheme were initially well below initial estimates but around 5,000 households had used the scheme by its close. Rescue schemes continued in Scotland as a government programme and also at local authority level.

The government now feels able to reduce the extent of the safety net for homeowners, with the introduction of universal credit and the switch to LMI in large measure a result of the relatively low level of arrears and repossessions that followed the 2007 downturn. However, as the UK Finance report argues, this downturn has been very benign primarily because of the way in which interest

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<sup>16</sup> Hansard (2017) *Mortgage Interest Payments: Answer to a written question by Caroline Dinéage*, Commons 117207, 7<sup>th</sup> December 2017, House of Commons.

<sup>17</sup> DWP (2015) *Welfare Reform and Work Bill: Impact Assessment for Converting Support for Mortgage Interest (SMI) from a benefit into a Loan*, <http://www.parliament.uk/documents/impact-assessments/IA15-006D.pdf>

rates have fallen since 2007, and partly because the downturn did not lead to the levels of unemployment previously experienced. In the event of a less benign downturn there are serious doubts about the adequacy of the homeowner safety net, and the government will need to be ready to step in with stronger measures.

### **Other policies**

In addition to the housing programmes outlined above, reference should be made to quantitative easing and the other monetary and credit policies undertaken by the Bank of England over the past decade. So, for example, the Term Funding Scheme and predecessors such as the Funding for Lending Scheme have granted the banks and other lenders access to around £550 billion of funding at preferential rates. This is passed through to lending partly in the residential market. Credit supply via mortgages makes demand for homeownership effective so this, as well as the various Help to Buy and related schemes, have also helped stimulate activity (and prices), although once more it is difficult to fully assess their net market impact.

Undoubtedly the years since the 2007 crash have been particularly difficult for the private sector housing market. It has seen major changes in regulatory measures and the tax treatment of private rented housing, as well as all the policy initiatives outlined in this section. Despite all this we still have what has been described as a ‘broken housing market’, with homeownership rates well below previous highs and only a gradual recovery in levels of new housing supply.

### **Social housing finance**

The most substantial form of financial support for social housing is in the form of housing benefit for low-income households. There are also substantial grant funds provided to support investment in new social and affordable homes in England, Scotland and Wales, primarily by housing associations. There is no longer any continuing subsidy for council housing, and indeed in recent years central government extracted surpluses from council rents in England and Wales. However, following one off ‘buy outs’ that generated over £9 billion for HM Treasury, the annual (net) negative subsidy regimes in England and Wales have now been brought to an end.<sup>18</sup>

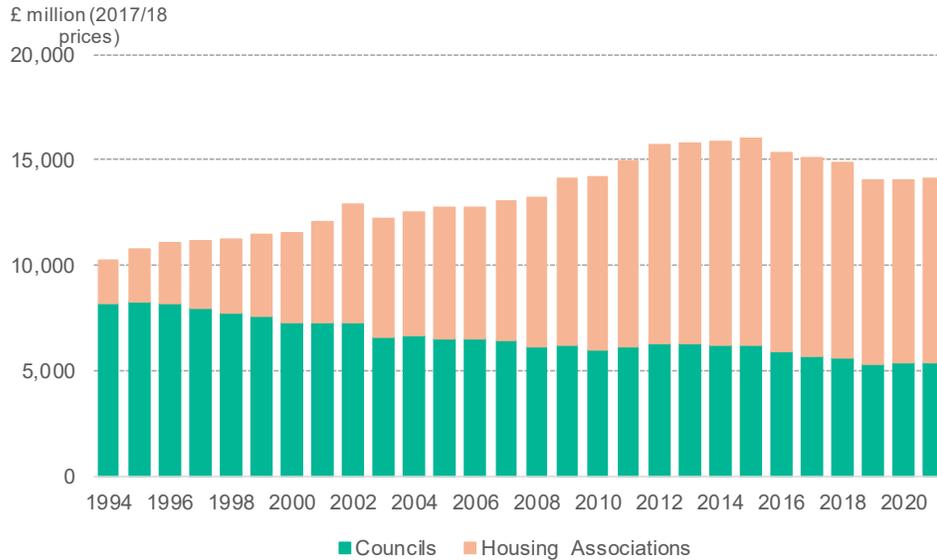
Currently housing benefit expenditure for the social rented sector (in Great Britain) is running at some £15 billion annually (see Figure 8 below). Expenditure grew in real terms over the decade to 2012/13, primarily in response to government policies to raise rents broadly in line with earnings and a little ahead of inflation. However, housing benefit expenditure for the sector is now falling, following a government decision to reduce social sector rents (by 1% a year) for four years from April 2016. Beyond that period government has now announced that rent increases of CPI plus 1% a year can resume, and has subsequently dropped a proposal to apply the private sector LHA limits to the social rented sector.<sup>19</sup> Both these measures will enhance the investment capacity of social landlords.

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<sup>18</sup> As reported in the *UK Housing Review*, for example in 2013 and 2017.

<sup>19</sup> The central government policies on rent increases and reductions apply to England only, as this is an aspect of housing policy where decisions are devolved to the Scottish and Welsh Governments.

**Figure 8: Social housing sector housing benefit expenditure in Great Britain, 1994-2021**



Source: DWP.

Note: Years are financial years.

All net capital expenditure on social housing currently counts against government public spending measures, as shown in Figure 9 below. A large proportion of local authority capital spending is ‘self-financed’, that is funded either by capital receipts or directly from rental income. The balance is predominantly funded by borrowing, with a small element coming from a variety of forms of grant, including grant to support new house building in Scotland. The great majority of the spending is on major repairs and improvements to the council housing stock, but there are also small levels of spending on new council house building. Expenditure on private sector improvement grants is not included here, as that constitutes support for the private housing sector.

The largest element of expenditure that features in government departmental budgets is the provision of grants to support housing association investment in new affordable housing, in the form of social rent, Affordable Rent and shared ownership homes. In recent years investment in England has switched from social rent to Affordable Rent, the difference being that the latter have higher rents, albeit still some way below market levels (typically 50% lower than market levels in London, and about 20% lower in the rest of England). In Scotland and Wales funding is still focused on the provision of social rented dwellings, with only limited provision for ‘affordable’ rented dwellings that are targeted at households with ‘intermediate’ incomes.

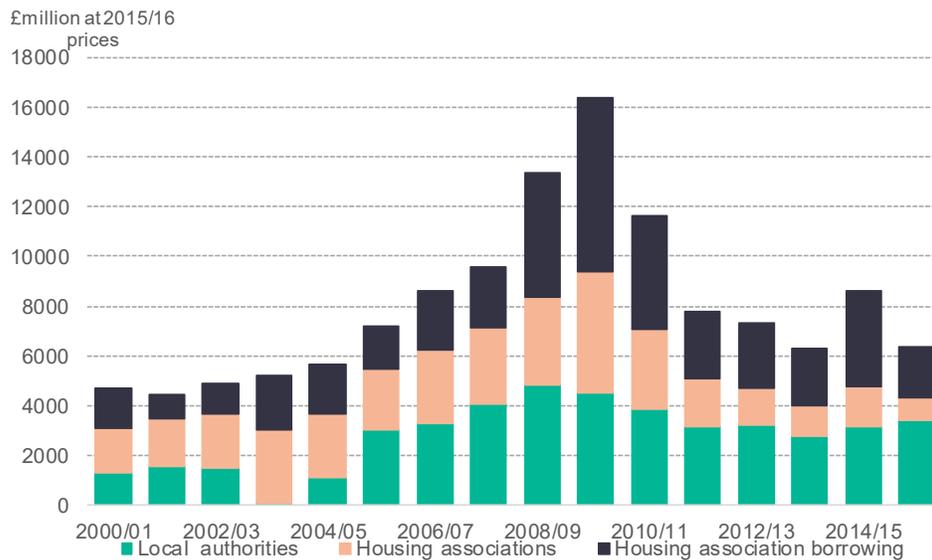
Looking ahead, funding for housing association social and affordable supply is set to increase, with additions to the budgets for the years to 2020/21. The November 2017 Budget confirmed an additional £2 billion for the Affordable Homes Programme in the years to 2020/21. It also announced that local authority housing borrowing caps will be selectively increased to permit £355 million, £265 million and £260 million additional investment respectively in the three years from 2019/20.

For England the affordable housing budgets are now set to increase to an average of £1.8 billion a year (for the five years from 2016/17), up from just £544 million in 2015/16; with the further addition of the £620 million permitted council borrowing in the last two of those years. There are likely to be increases of similar proportions in the equivalent budgets in Scotland and Wales, but those budgets are only set one year at a time.

Housing association borrowing did not count against government spending measures, as it was classified as private sector borrowing. However, in 2015 following a review by the ONS, housing associations were reclassified as public sector corporations, on the basis that the level and form of regulation they were subject to by government was such that they are deemed to be publicly controlled, albeit not in government ownership.<sup>20</sup>

Consequently, that borrowing counted against measures of public sector borrowing and debt. This did not, however, lead to any greater controls over housing association borrowing, and indeed the government loosened the regulatory framework for the sector, so that in November 2017 the ONS was able to announce it was restoring their classification as private sector (non-profit) corporate bodies; their borrowing once again falls outside public sector borrowing and debt measures.

**Figure 9: Social housing capital expenditure in Great Britain, 2000/01 to 2015/16**



Source: *UK Housing Review*, Tables 58 and 59.

Note: Housing association funding includes that channelled through local authorities.

While it does not enter into any public sector accounts there is also an economic subsidy to the social rented sector, in the form of the opportunity cost represented by their sub-market levels of rents. Figures on the extent of that economic subsidy are not routinely available, but an analysis

<sup>20</sup> Wilcox, S. (2017) 'Some reflections from 25 years of the UK Housing Review', in Stephens, M. *et al*, *UK Housing Review 2017*.

undertaken as part of a review of social housing rents and finances in 2008 estimated that the economic subsidy conveyed by sub-market rents in England in 2007/08 was of the order of £7 billion.<sup>21</sup> While this represents a very substantial transfer of economic value to the tenants, in practice if rents were raised to market levels the great majority of the additional rental income would be offset by increased housing benefit costs. Until the freeze on English rents was introduced in April 2016, social sector rents had been increasing more rapidly than private rents, and this suggests that the current value of the economic subsidy from sub-market rents will have declined from its 2007/08 level. It will, however, increase again over the four-year period of the social rent freeze.

Arriving at a 'total' figure for government support to the social rented sector is complicated both by different perspectives on the appropriateness of including different components, and also on the incompleteness of available data relating to those components. If housing benefit and support for social sector housing investment alone are counted, then this currently amounts to some £20 billion per annum. If, however, housing association borrowing and the economic subsidy from sub-economic rents are also included, then the total rises a good way towards £30 billion per annum.

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<sup>21</sup> Wilcox, S. (2008) *Social Rents and Economic Subsidies*, Working Paper, Housing Revenue Account Review. London: DCLG.

### 3 Taxation measures and tax reliefs

Various taxes and tax reliefs are of significance for the homeownership and private rented sectors. These differ for each sector, and have changed in their scope and significance over time. The main taxes (and reliefs) considered in this section are income and corporation tax, council tax, capital gains tax, inheritance tax and stamp duty, plus a few relatively short-lived or recent smaller taxes. The section begins with the taxes that relate to the use value and running costs of housing, then moves on to those that relate to the asset value of housing. It is quite evident that the data on tax related to private landlords is quite poor. HMRC often does not separate out residential landlords. We return to this issue later.

#### Income tax

The tax treatment of mortgage costs, for both homeowners and private landlords, dates back to the origins of income tax at the beginning of the 19<sup>th</sup> century, and at least initially was intended to affect the two sub-sectors in an equivalent fashion. As at that time private renting was far more common than owner-occupation, the arrangement for private renting was the starting point. Interest paid on mortgage loans for a private rented dwelling were, from the very beginning, treated as an allowable expense against the rental income received from letting the property.

Following on that premise that there is a value, and at least a potential rental income, to be derived from property ownership, homeowners were subject to a tax on the notional rental income of their home, albeit that it was recognised that they consumed that income in kind, rather than in cash. This element of income tax came to be known as 'Schedule A' tax. Following the same logic, homeowners were also permitted to claim their mortgage interest costs as an allowable expense against their Schedule A tax liabilities.

These arrangements became of greater significance in the years after 1918, when income tax began to apply to a much larger proportion of households. And although these measures began with the intention of providing some parity in the treatment of homeowners and private landlords, in practice the arrangements came to be more favourable to homeowners as the notional rental values applied for Schedule A tax were only updated periodically and were typically set relatively low compared to full market values. The more favourable treatment of homeowners was made more explicit in 1963, when Schedule A tax was abolished, but owners were left 'with all their old rights to deduct interest payments from their taxable income'.<sup>22</sup> That arrangement then continued for over 30 years, until mortgage interest tax relief (MITR) for homeowners was eventually abolished in April 2000.

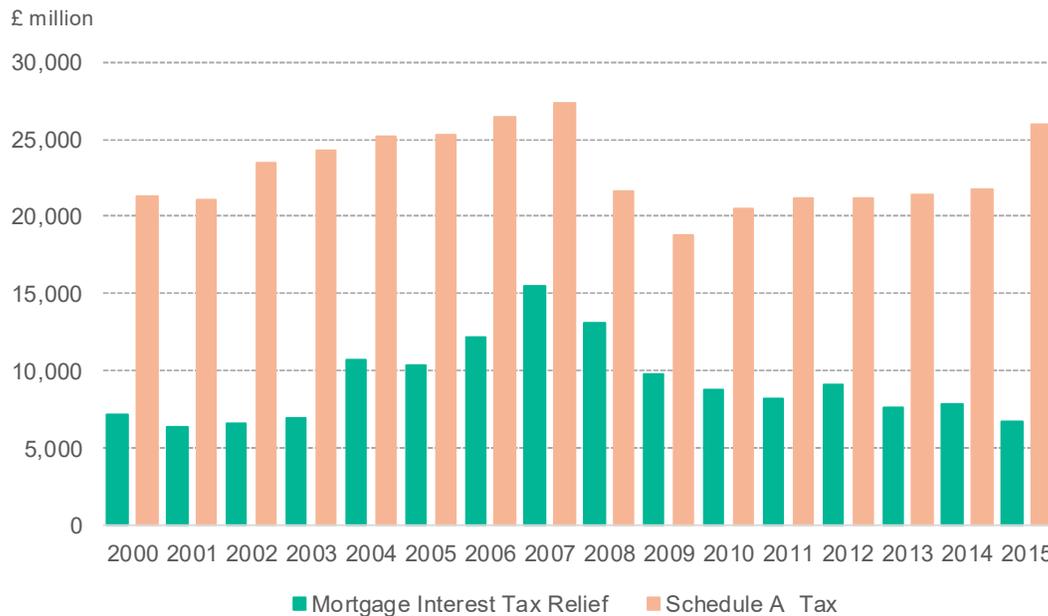
If this favourable treatment of income tax for homeowners was clearly a factor throughout that sustained period of growth in the sector, their potential tax advantage relative to private landlords did not simply end with the abolition of MITR. This is because typically the total value of Schedule A

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<sup>22</sup> Nevitt, A. A. (1966) *Housing, Taxation and Subsidies*. London: Nelson.

tax (if at full market value) would by far exceed the value of MITR, as can be seen in the hypothetical estimates set out in Figure 10.<sup>23</sup>

**Figure 10: Hypothetical values of Schedule A tax and mortgage interest tax relief in the UK, 2000 to 2015**



Source: *UK Housing Review 2017*, Table 2.6.1.

The hypothetical figures show a significant continuing fiscal advantage to homeowners as a whole, but it should also be noted that there are important distributional advantages. The most substantial ones would be for established homeowners with little or no mortgage, who had the full benefit of the abolition of Schedule A tax, as they would not have had that offset by any (or very little) MITR. In contrast first-time buyers with a substantial mortgage would gain little from the current arrangements, as in their case their Schedule A tax liability would be largely (or fully) offset by MITR. Indeed, the substantial net benefits of these long-term changes in tax arrangements for established owners are reflected in higher house prices. By contrast, current first-time buyers have lost those benefits even though they do benefit from very low current interest rates.

The tax arrangements for the private rented sector have, until recently, been relatively straightforward, and pretty much followed standard principles as applied to other businesses. Within that context there have been different approaches over time in defining and dealing with management and maintenance costs to be permitted as offsets against rental income for tax purposes. With the growth of the sector the tax yield it provides has also grown.

<sup>23</sup> These estimates are based on estimates of the total value of owner-occupied stock in the UK, average mortgage interest rates, estimated net rental rates of return based on the IPD Index, and the standard rate of income tax. For further details see Table 2.6.1 in the *UK Housing Review 2017*.

HMRC data show personal net incomes of some £15 billion from property in 2014/15.<sup>24</sup> While some part of this will relate to non-residential property, it does not include the dividend income from corporately owned rented dwellings, which account for some 28% of all private rented housing.<sup>25</sup> Together this suggests total net income from the sector of some £20 billion, and a likely tax yield of some £6 billion. Given that in that year the total private rented housing stock was valued at £1.16 trillion,<sup>26</sup> this suggests a net rental yield of less than 2%, and a tax yield of some 0.5%.

All things being equal, with the value of the PRS housing stock estimated to have risen to £1.4 billion by 2016,<sup>27</sup> this would suggest that net rental incomes rose to some £24 billion in that year, and the tax yield to just over £7 billion. While the reported net income from private renting looks low compared to estimates of a commercial rate of return, it must also be recognised that not all private landlords charge full market rents, and that even more commercially minded landlords do not always fully uprate rent levels for existing 'good' tenants.<sup>28</sup> Nonetheless the relatively low level of net income reported by private landlords has given rise to questions about the extent to which they are fully declared for tax purposes.

In the 2010 Tax Gap report it was estimated that £142 million of tax was unpaid on lettings and £55 million of capital gains tax on land and property – of which residential landlords would have been a part. We have not identified more recent estimates. HMRC launched the Let Property Campaign in 2013 focused on the residential property letting market with the aim of assisting landlords to get their tax right from day one – to December 2016 it had resulted in over £115 million in additional tax, interest and penalties. Industry estimates indicate that HMRC believes that one in three landlords are failing to declare rental income, with this tax evasion amounting to an estimated £550 million per annum.

In 2013 an Intergenerational Foundation report argued strongly that the tax treatment of landlords was too favourable.<sup>29</sup> But the report effectively ignored the fact that landlords were treated in much the same as any other business in terms of reliefs. However, the politics of housing intervened in 2015 when Chancellor George Osborne announced a number of measures that were intended to improve the competitiveness of first-time buyers relative to investors in private renting. The key provision was to limit private landlords' eligibility for tax relief against their mortgage interest costs, to the basic rate of tax from 2017/18 onwards, with transitional provisions meaning that the measure only becomes fully operational in 2020/21. Alongside that change, the provision of a 10% 'wear and tear' allowance against rental incomes was also ended and landlords can only now claim for actual costs incurred in maintaining their property. At the same time the government introduced

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<sup>24</sup> HMRC (2017) *Property, interest, dividend and other income*, Table 3.7, Survey of Personal Incomes. London: HMRC.

<sup>25</sup> DCLG (2011) *Private Landlords Survey 2010*. London: DCLG.

<sup>26</sup> Savills (2015) *Constituencies of Housing Value*, Residential Property Focus, 2015 Issue 1. London: Savills.

<sup>27</sup> Savills (2017) *How much is the UK worth?*, Residential Property Focus, 2017 Issue 1. London: Savills.

<sup>28</sup> Rugg, J. & Rhodes, D. (2008) *The Private Rented Sector: its contribution and potential*. York: Centre for Housing Policy, University of York.

<sup>29</sup> Kingman, D. (2013) *Why BTL equals "Big Tax Let-off": How the UK tax system hands buy-to-let landlords an unfair advantage*. London: Intergenerational Foundation.

new provisions for stamp duty to be paid by landlords, which are discussed further below, again with the objective of further tipping the balance on market entry in favour of first-time buyers.

The impact of the changes to mortgage interest tax relief (MITR) and cost allowances will vary significantly across the sector, due to the diversity of its structure. The change will have no impact on small landlords with limited incomes and who are not in any event liable for higher rates of tax. Indeed, one recent estimate suggests that only about a quarter of all landlords will be affected.<sup>30</sup> Nonetheless one outcome is that more landlords will become subject to higher-rate tax, and there will be a marked increase in the tax yield from these reforms, estimated by the Treasury to reach £840 million by 2020/21.<sup>31</sup>

The numbers of corporate landlords in the sector are very small,<sup>32</sup> but it is notable that they are not subject to these changes. Indeed, while the issues involved in operating as limited companies are multi-faceted, the new MITR rules make it relatively advantageous for private landlords to become corporations, especially in respect of new investments. In addition to continued access to full MITR, incorporation also brings with it the advantage of the lower rates of corporation tax. This currently stands at 19%, and is set to reduce further to 18% in April 2020. However, to date there is only limited evidence that existing landlords are thinking about transferring their properties into limited companies, not least because this would potentially involve capital gains tax and stamp duty costs on existing dwellings at the point of incorporation. This may change over time as the tax impacts become clearer.

Another group of landlords unaffected by the MITR change are the small landlords that just let out a room (or rooms) in their own home. Indeed, the tax exemption for rental income for resident landlords letting out their own rooms was increased from £4,250 a year to £7,500 a year from April 2016. However, data from the English Housing Survey suggest that the numbers of tenancies provided by resident landlords have remained relatively static over the last two decades, and that they currently account for less than 2% of all lettings.<sup>33</sup>

### **Council tax**

While not a fully-fledged tax on the use value of a dwelling, council tax does have some of these characteristics, as it is at least to some extent related to property values. It is however levied on occupiers in all tenures, not just on property owners, and in England the top rate of council tax currently applies to properties valued at over £320,000 in 1991, or just over £1m in current values.

The value ranges for each council tax band vary as between England, Scotland and Wales, and in Wales were revised from 2005 following a 2003 revaluation of all properties. There are eight property value bands for council tax in England, ranging from Band A (for properties valued at

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<sup>30</sup> Scanlon, K. and Whitehead, C. (2016) *The profile of UK private landlords*. London: CML.

<sup>31</sup> HM Treasury (2016) *Budget 2016*. London: HM Treasury.

<sup>32</sup> Estimated at some 3%-5% of all private landlords, but due to their larger than average portfolios estimated to account for some one in six of all privately rented dwellings. See DCLG (2011) *Private Landlords Survey 2010*. London: DCLG, and Scanlon, K. & Whitehead, C. (2016) *op.cit.*

<sup>33</sup> DCLG (2011) *English Housing Survey 2014-15: Private Rented Sector Report*. London: DCLG.

£40,000 and under at 1991 values), up to Band H (for properties with values in excess of £320,000 at 1991 values).

Although central government funding is the largest contributor to the costs of local council services, council taxes nonetheless raise very substantial sums relative to other forms of residential property-related taxation, as shown in Table 2. These figures are for council tax from dwellings in all tenures, as separate data on each tenure are not available.

**Table 2: Council tax income in Great Britain, 2013/14 to 2017/18**  
**£ million**

	2013/14	2014/15	2015/16	2016/17	2017/18
England	23,848	24,558	25,318	25,637	27,158
Scotland	1,978	2,022	2,033	2,053	-
Wales	1,422	1,494	1,567	1,633	1,705
Great Britain	27,248	28,074	28,918	29,323	-

Sources: Local Government Finance Statistics data for each country.

Notes: English figures are council tax collected for the years to 2015/16; council tax requirements for 2016/17 and 2017/18. Scottish figures are all for council tax collected, including the 2016/17 figure which is an estimate. Welsh figures are for council tax budget requirements. Figures do not include provisions for council tax support schemes.

The hybrid nature of council tax, which is primarily seen as a payment towards the costs of local council services, is also expressed in the provision that single occupiers of a dwelling can apply for a 25% reduction in their council tax liability, to reflect the presumed lower level of demand they place on council services. However, viewed from the perspective of a property tax, this provision can be seen as providing an incentive to under-occupation.

Council tax has been subject to a plethora of criticisms. There are the anomalies that arise in the differentials depending on whether a property has a value £1 above or below one of the tax band boundaries, the regressive nature of the tax that bears more heavily on lower rather than higher-value dwellings, and the anomalies that arise from the failure to regularly update the property valuations on which the tax is levied. In 1991 average house prices in London were just 36% higher than the average for England as a whole – by the first quarter of 2017 the London average was more than double that for England.

While all of these issues were considered by the Lyons Inquiry that reported in 2007, nothing ever came of its reform proposals.<sup>34</sup> Since then central government in England has intervened to restrict council tax rises, and made the system even more complicated by recently permitting an additional adult social care precept of up to 3%. It has also abolished the uniform council tax benefit that provided means-tested help for lower-income households, leaving councils to devise their own means-tested support schemes, with the caveat that benefits should not be cut for pensioner households. In Wales, as noted above, council tax values were reset to 2003 levels in 2005 and a new higher value band created. In Scotland, higher rates have been applied, from this year, to

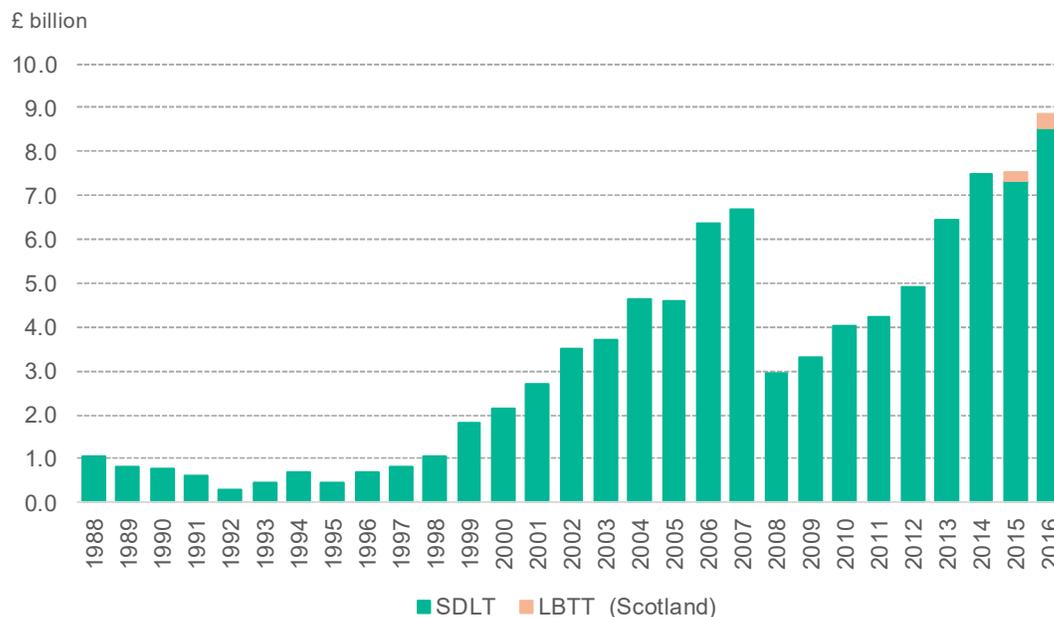
<sup>34</sup> Lyons, Sir M. (2007) *Lyons Inquiry into Local Government: Final Report*. London: The Stationery Office.

dwellings in the top three existing valuation bands. However, in both cases these reforms only serve to marginally reduce the regressive nature of the tax, which proportionately still bears significantly less on higher-value dwellings. The regressive and uneven character of the tax has been highlighted in a recent report for the London Finance Commission.<sup>35</sup>

### Stamp duty

After council tax, stamp duty land tax (SDLT) is the most significant residential property tax in terms of the annual yield to HM Treasury. That yield has grown substantially since the turn of the century, partly reflecting the general rise in house prices over the period, but also a series of reforms that progressively increased the rate of the tax applied to higher value dwellings (see Figure 11). The latest estimate for SDLT revenues in 2016/17 is just over £8.5 billion. However, since 2015/16 the SDLT figures are only for England, Wales and Northern Ireland, as from that time Scotland has levied its own property transaction taxes instead of SDLT. In 2016/17 the land and buildings transaction tax (LBTT) in Scotland was forecast to raise £466 million.<sup>36</sup>

**Figure 11: Stamp duty on residential dwellings, 1988 To 2016**



Source: HMRC & Revenue Scotland.

Notes: Years are financial years.

A further reform to the SDLT regime was to levy an additional 3% rate on purchases by individual private landlords, and people buying second homes, which has been applied since April 2016. A

<sup>35</sup> Wingham, M. (2017) *Council Tax in London: A publication for the London Finance Commission*. London: GLA Economics.

<sup>36</sup> Scottish Government (2017) *Government Expenditure & Revenue Scotland 2016-17*. Edinburgh: Scottish Government.

parallel Additional Dwelling Supplement has also been introduced in Scotland. The current basic scale rates for these property taxes are set out in Table 3, including the rates that have now been set, under newly devolved powers for Wales, that apply from April 2018.

In all cases this shows the basic scale rates for each property value band; to those basic rates has to be added the 3% additional levy for purchases by private landlords, and people buying second homes. However the 3% additional levy does only apply to dwellings with a minimum value of £40,000.

**Table 3: Stamp duty land tax and land and building transaction tax rates in Great Britain**

England & N Ireland		Scotland		Wales	
Value Bands	Rate	Value Bands	Rate	Value Bands	Rate
£0 - £125,000	0%	£0 - £145,000	0%	£0 - £150,000	0%
£125,001 - £250,000	2%	£145,001 - £250,000	2%	£150,000 - £250,000	2.5%
£250,000 - £925,000	5%	£250,001 - £325,000	5%	£250,000 - £400,000	5%
£925,000 - £1,500,000	10%	£325,001 - £750,000	10%	£400,000 - £750,000	7.5%
Over £1,500,000	12%	Over £750,000	12%	£750,000 - £1,500,000	10%
-	-	-	-	Over £1,500,000	12%

Source: *UK Housing Review 2016*; updated.

Note: The tax rates apply only to the element of value within each value band; not to the total value of the dwelling (as under earlier versions of SDLT).

Following the 2017 Autumn Budget there has been a further change in England, with first-time homeowner purchasers (from 22<sup>nd</sup> November 2017) exempt from SDLT for all purchases with a value up to £300,000. For purchases of dwellings with a value of up to £500,000 they will now pay nothing in respect of the first £300,000 of value, and 5% for the balance of value between £300,000 and £500,000.

This measure is forecast to cost £1,880 million in the four years to 2020/21, and £1,310 million in the two subsequent years. It will, as intended, provide first-time buyers will a degree of market advantage, especially compared to (non-corporate) buy to let investors who must now pay 3% in addition to the basic rates of stamp duty. It will also reduce the amount of capital first-time buyers require to enter the market (by up to £3,500) but, against that, the measure is also expected to put some upward pressure on house prices.

The costs of this measure are also factored in to the 'Barnett consequentials' that add to the budgets for the devolved administrations. However, at the time of writing, no decisions on whether to make any similar or equivalent changes to residential land tax duties have been made in Northern Ireland, Scotland or Wales.

It is too early to evaluate the impact of the recent series of reforms to the land taxation arrangements, and in particular the application of a higher rate of taxation to private landlords and second homeowners. In any event these measures cannot be seen in isolation given the reforms to

the income tax regime for private landlords discussed above. A broader consideration of the relative tax treatment of homeowners and private landlords follows at the end of this section.

What can be said is that the move away from the 'slab' structure of SDLT, where once a threshold property value was crossed the higher rate of tax applied to the whole of the property value, has been broadly welcomed as it removed the anomalies relating to property values just above each threshold. The criticism that continues to apply to stamp duty is that as a transaction based tax it acts as a tax on mobility, in that someone who moves more frequently will pay much more in tax than someone who moves infrequently. This criticism has increasing force now that the tax involves such substantial sums. While other economic and housing market changes are involved, it has been estimated that there are some 320,000 'missing movers' each year, and the increasing costs of stamp duties are seen as one of the factors contributing to the reduced mobility of existing homeowners.<sup>37</sup>

There is a parallel impact on landlords who face a disincentive against updating their property portfolios. Nonetheless it is clearly the case that for successive governments it has been easier to levy higher rates of stamp duty than to consider other property tax reforms.

### **Capital gains tax**

When landlords sell their properties, capital gains tax (CGT) is applied to the difference in the value of the property between the time of its acquisition and its disposal. This tax is also applied to 'second homes', but sales of primary homeowner residences are exempt. One of the countries that do apply CGT to main residences, along with a provision for roll-over relief, is Sweden. In broad terms it has been estimated that the provision for roll-over relief reduces the annual yield by around one third.

Estimates are set out here (Figure 12 below) of the value of the yield from main residences that would arise if CGT were to be applied with roll-over relief, and in other respects mirrored the provisions made in respect of those assets to which UK CGT does apply. Clearly these estimates must be treated with caution, and can only provide a ball-park indication of the net value of the main residence exemption from CGT. But the key point is that the value of the CGT main residence exemption is on any reckoning very substantial when set against the yield from those taxes that are applied to homeowner dwellings.

Estimates for years prior to 2012/13 are not set out here as the HMRC estimates for those years were arrived at by an earlier HMRC methodology; these provided significantly lower estimates than those derived from their latest, revised methodology.

The amounts actually raised by CGT from residential property are far lower. Residential property accounted for 14% of all chargeable gains in 2013/14, and pro rata this suggests a CGT tax take of just some £775 million in the year. From April 2015 onward the yield has been increasing as a result of the Autumn Statement 2013 decision to apply CGT to UK properties sold by foreign investors. This is forecast to yield amounts rising to £190 million in 2019/20.<sup>38</sup> The extent to which, in the medium term, this will impact on the levels of foreign investment in residential property in the UK (and

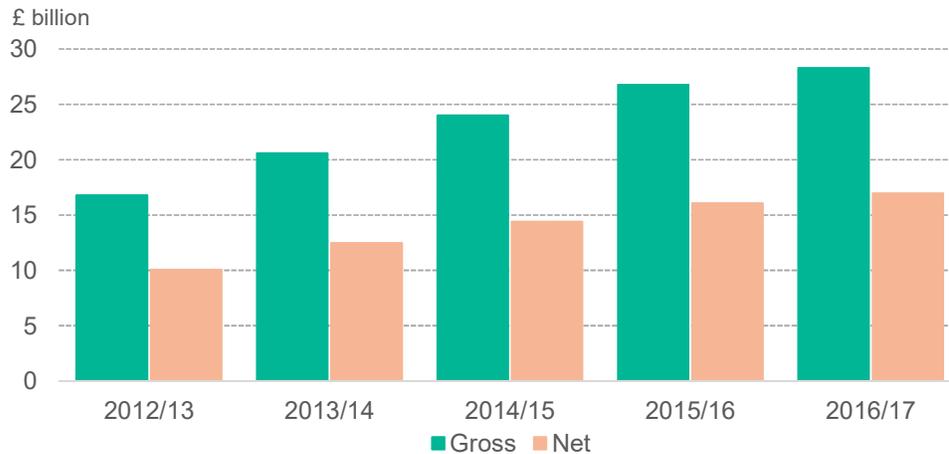
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<sup>37</sup> Hudson, N. & Green, B. (2017) *Missing Movers – A Long-Term Decline in Housing Transactions?* London: CML.

<sup>38</sup> HM Treasury (2015) *Budget (March) 2015*. London: HM Treasury.

London in particular) remains to be seen. The proportion of the CGT tax on residential property that applies to private landlords, rather than owners of second homes, is not known. More generally total CGT receipts are projected by the OBR to double by 2020/21.

**Figure 12: Estimates of the value of capital gains tax exemption on main residences, 2012/13 to 2016/17**



Source: HMRC & author calculations.

Note: Gross estimates are from HMRC. Net estimates are 40% lower, adjusted to illustrate the potential reduction resulting from the provision of roll-over relief.

Estimates of the value of this tax relief are provided annually by HM Treasury in Budget documents. Recent estimates show the value of this tax relief rising from £16.8 billion in 2012-13 to £26.8 billion in 2015-16, with a forecast of £28.3 billion in 2016/17. These estimates come, however, with the caveat that – were CGT to be applied to primary residences – this would push down property values, and as a result the actual CGT realised would be that much lower. A further caveat is that these estimates simply assume CGT is levied in full at every point of sale. In practice in those countries where CGT is applied to main residences it is typically accompanied by a provision for roll-over relief when homeowners move from one home to another. In this context CGT is only effectively applied at the point a homeowner either trades down or out of the market. If such a provision is assumed in the event of CGT applying, then in turn this would further reduce the estimated value of full CGT relief on main residences.

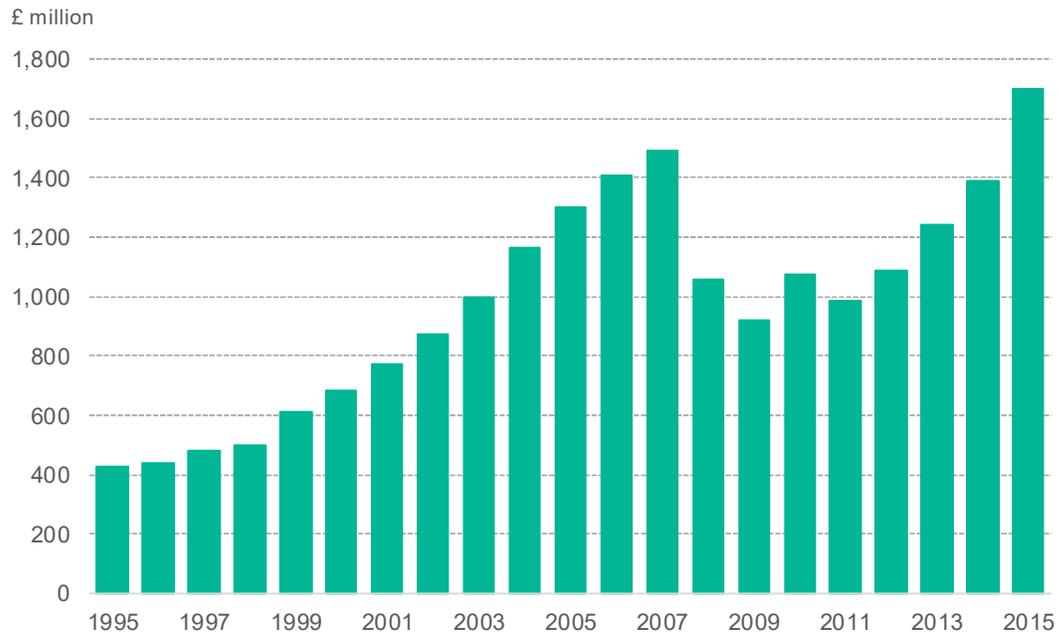
### **Inheritance tax**

Inheritance tax (IHT) is essentially a wealth tax applied to an estate following a person's death. While the transfer of ownership of the family home to a surviving marital partner is exempt from the tax, for all other transfers the wealth embodied in a homeowner's dwelling is, along with other assets, subject to IHT.

Estimates of IHT based on residential property are derived from data on the proportion of residential property wealth as a proportion of total assets for those estates where the total value means that they are subject to the tax (see Figure 13 below). In practice this involves only a small minority of

estates – some 7% in 2013/14. As a result of house price rises over recent decades the proportion of estates due to be subject to IHT was expected to increase. In reality as a result of recent reforms it is now expected that it will fall.

**Figure 13: Inheritance tax based on values of residential dwellings in the UK, 1995 to 2015**



Source: HMRC.

After several years when the IHT threshold was gradually raised, since 2009 it has remained fixed at £325,000. However this is per person, so for couples the threshold is potentially £650,000. Since April 2017 there has been an additional threshold allowance for transfers of housing wealth to direct descendants (i.e. children or grandchildren). Initially this has been set at £100,000 in 2017/18, rising incrementally to £175,000 in 2020/21.<sup>39</sup> As with the basic threshold, these allowances are per person, and are transferable in the case of couples thus doubling their potential value. Taken together they mean that by 2020/21 couples will effectively be able to pass on housing wealth of up to £1 million without any liability for IHT, compared to a £650,000 maximum before April 2017.

#### **Total net impact of residential property taxation**

In overall terms the **tax reliefs** available to homeowners clearly have a very substantially greater value than the **revenues from the taxes** that are effectively applied to the sector. The extent of the net fiscal advantage to the sector can, however, only be broadly estimated, as while the tax reliefs (amounting to some £40 billion in 2016/17) are specific to the sector, the residential property taxes that are applied (yielding some £11 billion in 2016/17) relate either to all tenures (stamp duty) or to

<sup>39</sup> There are also 'downsizing' provisions to prevent any loss of entitlement to these additional allowances where a smaller property is below the threshold value.

all ownership of private housing (IHT). From this it can be estimated that the overall net tax advantages to the homeowner sector are worth something over £29 billion a year (Table 4).

In the same year the total raised through council tax was of the same order. However this relates to households in all tenures, as outlined above, as it is something of a hybrid tax that is levied on occupation rather than ownership. It is thus far from clear that this should be taken into account in the same way as the taxes and tax reliefs that relate to property ownership.

**Table 4: Private owner taxes and homeowner tax reliefs in the UK, 2012/13 to 2016/17**

*£ million*

Year	2012/13	2013/14	2014/15	2015/16	2016/17
<b>Private owner taxes</b>					
Inheritance tax	1,089	1,244	1,511	1,846	1,912
Stamp duty	4,905	6,450	7,500	7,510	8,885
Gross tax	5,994	7,694	9,011	9,356	10,797
<b>Homeowner tax reliefs</b>					
Imputed rental return*	-12,100	-13,800	-13,900	-19,300	-21,300
Capital gains (gross)	-16,800	-20,600	-24,000	-26,800	-28,300
Capital gains (net)**	-11,088	-13,596	-15,840	-17,688	-18,678
Total net tax reliefs	-23,188	-27,396	-29,740	-36,988	-39,978
<b>Total net tax</b>	<b>-17,194</b>	<b>-19,702</b>	<b>-20,729</b>	<b>-27,632</b>	<b>-29,181</b>

Notes: The income from IHT relates to all private housing and the income from stamp duty relates to purchases in all tenures. The imputed rental return\* tax relief is net of provision for offsetting mortgage interest costs. The net capital gains\*\* estimate makes provision for roll-over relief. See text above and the *UK Housing Review 2017* for further notes on the logic and methodology of net tax relief estimates.

In contrast it might be broadly estimated that the total tax yield from the private rented sector is currently of the order of £8 billion (based on income tax, corporation tax and capital gains tax), or perhaps some £9 billion if a proportion of the yields from stamp duty and inheritance tax are included. The differences in the tax regimes as they apply to homeowners and private landlords have been accentuated by the recent reforms to taxes for the PRS. The rationale for the reforms for landlords (including foreign investors) is to counter-balance the competitive advantage that private investors have in the private housing market with respect to interest-only loans and off-plan sales.

The revised tax arrangements are, however, ad hoc and are anomalous when considered alongside tax arrangements for other forms of investment. However, by the end of the decade the various tax reforms are expected to raise just over an additional £1 billion annually.

Within the homeowner sector there are also significant variations in the implied impact of the taxes as between households with different value dwellings, and as between first-time buyers and well established outright owners.

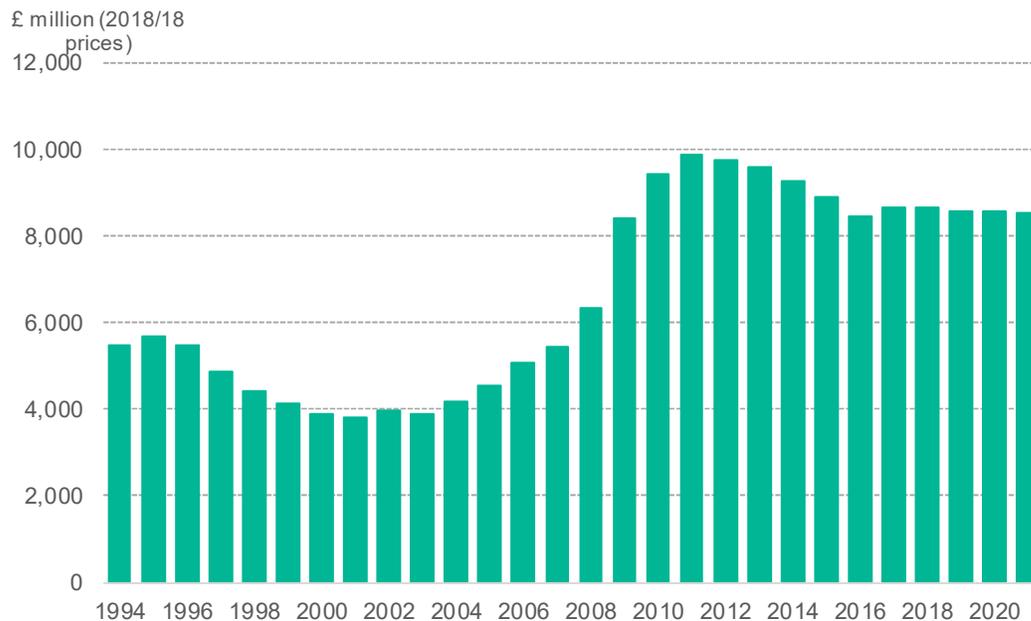
## 4 Measures of market regulation and deregulation

Although regulation is very much a secondary element in this report it is included because it frames the market and conditions how it operates. Here we only cover the most direct regulatory matters.

### Private rented sector

Since 1989, private sector rents in most of the UK have not been subject to any substantive regulation,<sup>40</sup> although we are now seeing divergence in Scotland and Northern Ireland. And while housing benefit has long been seen as ‘taking the strain’ more recently there has been growing concern about its rising cost (see Figure 14).

**Figure 14: Housing benefit expenditure in the UK private rented sector, 1994 to 2021**



Source: DWP.

Notes: Years are financial years.

As Wilson comments ‘in 2013 the Department for Work and Pensions estimated that £2.9 billion (33%) of private sector housing benefit expenditure in 2010/11 could be attributed to real terms rent growth over the previous ten years’.<sup>41</sup> However, little of that rental growth could be attributed to landlord actions in relation to the housing benefit regime operating over that period. Indeed for

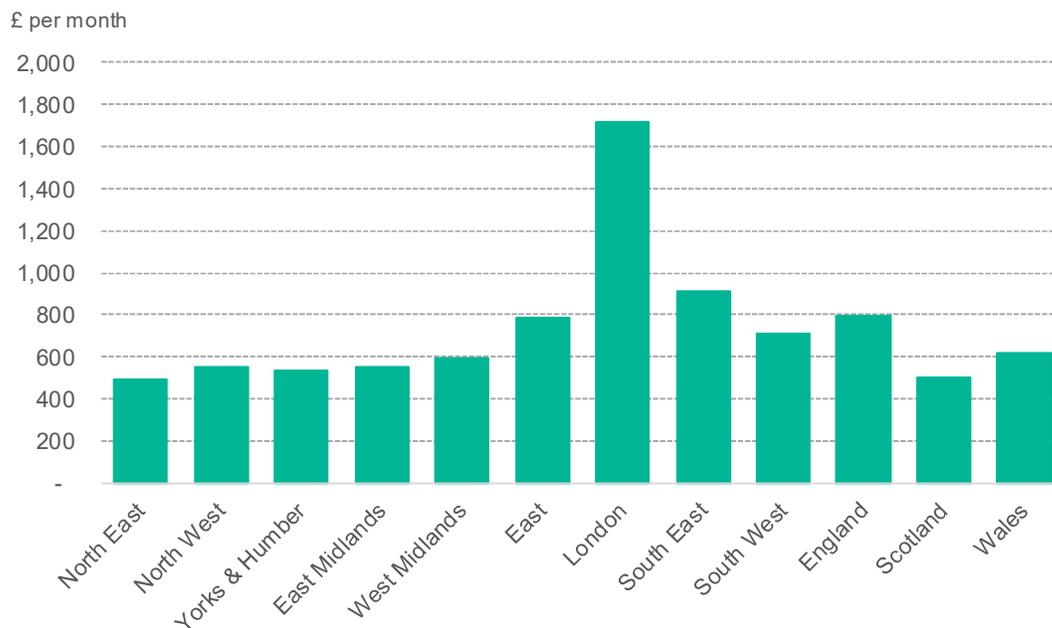
<sup>40</sup> There are limited requirements for rents not to be increased more than once a year, and provisions for appeals if a tenant considers the rent to be above market levels.

<sup>41</sup> Wilson, W. (2017) *Private rented housing: the rent control debate*, House of Commons Library, Briefing Paper Number 6760. London: HoC, and Wilson, W. (2017) *A short history of rent control*, House of Commons Library, Briefing Paper Number 6747. London: HoC.

most of that time rental growth lagged behind earnings growth, and for the whole period it ran below increases in mortgage costs.<sup>42</sup>

Nonetheless the government introduced a number of further restrictions on levels of private rents eligible for housing benefit. The principal reform included lowering the local housing allowances that set the maximum eligible rents in any area (from 2011), and then subsequently failing to uprate the new limits to reflect movements in market rent levels. This reform also included much sharper restrictions for single people aged under 35. These restrictions have had predictable impacts on the capacity of lower-income households to secure – and sustain – tenancies in the sector. As well as a broader decline in the numbers of private tenants in receipt of housing benefit since 2013, there has been a much greater reduction in the numbers of single under-35s, and the numbers in the areas of central London where eligible rents are ‘capped’.<sup>43</sup>

**Figure 15: Average private sector rents in 2016 by country and region**



Source: VOA, Scottish Government, Welsh Government.

Note: Mean price for two-bed dwellings.

As can be seen, those measures have reversed the previously rising trend in the costs of housing benefit for private tenants, and contained them at a level of about £8.5 billion per annum (at 2017/18 prices). With the growth of the PRS, and with rents in London at levels more than double the average for England as a whole, there have been growing demands for controls on rent increases

<sup>42</sup> Pawson, H. (2012) ‘The changing scale and role of private renting in the UK housing market’, in Pawson, H. & Wilcox, S. *UK Housing Review 2011/12*. Coventry: Chartered Institute of Housing.

<sup>43</sup> Wilcox, S. (2016) ‘A decade of diminishing welfare’, in Wilcox, S., Perry, J., Stephens, M. & Williams, P. *UK Housing Review 2016*. Coventry: Chartered Institute of Housing.

during the term of a tenancy. There is survey evidence to suggest there is widespread support for such measures.<sup>44</sup> The range of private sector rents across Great Britain is shown in Figure 15 above.

In addition, there is a growing debate about the need for longer-term tenancies reflecting the changing population of tenants, e.g. more families. The previous coalition government published a model tenancy agreement aimed at longer tenancies and more predictable rent increases and several manifestos for the 2017 general election argued for more controls and longer-term tenancies – a standpoint Shelter has broadly supported with the aim of bringing predictability into rental contracts. In Scotland, a new form of tenancy was introduced in December 2017; this provides greater security for tenants and measures that might cap the level of annual rent increases in any designated ‘high pressure’ areas. In particular, the new Scottish tenancy removes the ability of landlords to gain possession without due cause, although the landlord wishing to sell the property is included as a ground for possession, along with the more established grounds such as rent arrears.

### **Current regulation**

A landlord must:

- keep the rented properties safe and free from health hazards
- make sure all gas and electrical equipment is safely installed and maintained
- provide an Energy Performance Certificate for the property
- protect the tenant’s deposit in a government-approved scheme
- check the tenant has the right to rent the property if it is in England
- give the tenant a copy of the ‘How to rent’ checklist when they start renting
- if the home is three or more storeys high and occupied by five or more people the landlord must have an HMO licence; councils can also include other types of HMOs for licensing
- in Scotland, the landlord must register with the local council.

In terms of mortgage lending most buy to let (BtL) mortgages are unregulated by the Financial Conduct Authority (FCA). But so-called consumer BtL loans are regulated and require the same treatment as residential mortgages under the FCA rules. However these are understood to comprise only about 15% of new BtL business, and a much smaller proportion of outstanding loans.<sup>45</sup>

In late 2016, HM Treasury announced it was granting the Bank of England’s Financial Policy Committee (FPC) powers of direction in the BtL market, though these have yet to be used. More recently the Prudential Regulation Authority (PRA) has required regulated lenders to place limits on BtL mortgage lending in relation to loan-to-value (LTV) ratios within the affordability stress tests, and there is an expectation that interest-coverage ratios (ICRs) will also be increased. These stricter affordability tests include taking account of the impact of recent tax changes and a stress test on interest-rate rises (5.5%). Further restrictions on portfolio landlords were implemented from

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<sup>44</sup> Survey evidence includes London Assembly, Housing and Regeneration Committee (2013) *Rent reform; Making London's private rented sector fit for purpose*. London: GLA; Moore, T. and Dunning, R. (2017) *Regulation of the private rented sector in England using lessons from Ireland*. York: JRF, and Bentley, D. (2015) *The Future of Private Renting: Shaping a fairer market for tenants and taxpayers*. London: Civitas.

<sup>45</sup> Data provided by UK Finance.

September 2017 on what is termed ‘complex’ buy to let. These rules apply to new purchases and capital raising but BtL remortgages with no additional borrowing remain unaffected.

A significant, and continuing, feature of the BtL sector is that the predominant mortgage product is an interest-only mortgage (in 12 months to July 2017, 73% of BtL house purchase loans were advanced on this basis). The much lower repayments required for an interest-only mortgage, compared to a standard repayment mortgage now typically required for first-time buyers, gives BtL investors a significant competitive advantage in the market.

### **Homeownership**

We are regularly told that ‘an Englishman’s home is his castle’<sup>46</sup> – and setting aside any objections to the statement itself, the reality is that though there may be considerable freedom to act compared to a tenants, homeowners are constrained in a variety of ways through planning permissions, compulsory purchase orders, building regulations, boundary disputes, rights to privacy and quiet enjoyment plus of course the law related to mortgages. Homeowners do not enjoy complete freedom and indeed when we look more closely at examples such as shared owners or park homes owners that freedom is highly constrained.

Our focus here is on the regulation of the homeownership mortgage market. This, just as much as the taxation and housing policy measures considered below, has a significant impact on the shape of homeownership – who can access it or not and who can benefit from it and how. Set out below is a brief summary of the current mortgage regulatory regime.

### **Mortgage market regulation**

This is an area which has changed greatly since the 1990s housing market downturn, which triggered industry discussion about the case for an industry mortgage code to enhance protection for borrowers by raising standards within the lending industry. After consultation, a code for lenders took effect in July 1997 followed by an extension to intermediaries in 1998. The Mortgage Code Compliance Board (MCCB) along with its register of intermediaries ran through to 2004 when it was replaced by statutory regulation, following the Treasury review of banking service consumer codes and the Financial Services Authority’s (FSA) own consultation *Mortgage Regulation: The FSA’s high level approach*.

The mortgage code was effectively a bridge between an unregulated market and the now fully fledged regulated market (except in buy to let which remains for the most part unregulated). The Mortgage Conduct of Business rules came into effect on 31<sup>st</sup> May 2004 and effectively ‘grandfathered’ across lender and broker firms of ‘good standing’ and outstanding complaints to the FSA and the Financial Ombudsman Service (FOS).

The FSA set up a risk-based system of mortgage market regulation. In 2005 it conducted the first of two studies of the effectiveness of the mortgage conduct regime looking at responsible lending practices in the areas of sub-prime, interest-only, self-certified mortgages and lending into

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<sup>46</sup> Fox, L. (2007) *Conceptualising Home; Theories, Laws and Policies*. Oxford: Hart Publishing.

retirement. The FSA noted ‘weaknesses in responsible lending practices and in firms’ assessments of a consumer’s ability to afford a mortgage’.

However all this was overtaken by the Global Financial Crisis (GFC) in 2007/08, forcing the FSA to move its thinking beyond a narrow conduct focus to the wider prudential and macroeconomic context. In July 2010, the FSA consulted on *Mortgage Market Review: Responsible Lending* (MMR). But the government took the view that the system of regulation also needed changing after the GFC. As of April 1<sup>st</sup> 2013 the FSA was replaced by the PRA and the FCA, as part of a wider shake up.

The FCA has responsibility for ensuring that relevant markets function well, for the conduct supervision of financial services firms (as well as the prudential supervision of firms not supervised by the PRA). The PRA is in turn responsible for promoting the safety and soundness of deposit-taking firms, insurers and systemically important investment firms. The Bank of England has responsibility for protecting and enhancing the UK’s financial stability while the FPC, within the Bank, provides the mechanism for protecting and enhancing the stability of the UK financial system and, subject to that, supporting the government’s economic policies, including its objectives for growth and employment.

Given these changes the new MMR rules were finally introduced on April 26<sup>th</sup> 2014. They included:

- introduction of responsible lending rules which include an obligation to make sure that borrowers could afford to service and repay the loan they were taking out
- this in turn resulted in new requirements on the information collected about borrowers and the affordability tests that were then to be conducted
- stress-testing was to be carried out against future rate increases
- interest-only mortgages could only be recommended where the borrower presented a credible repayment strategy; relying on rising house prices, for example, was not acceptable<sup>47</sup>
- most mortgage sales were to be advised
- arrears charges and forbearance rules have been widened to cover all payment shortfalls and cost recovery rules were clarified
- lenders are prevented from removing concessionary rates because of payment problems.

In addition, the FPC were then granted powers of intervention which lenders have to pay regard to:<sup>48</sup>

- the loan-to-income (LTI) flow limit which requires lenders to stay within a 15% cap on total new lending at 4.5 times LTI or more
- lenders must apply an interest-rate stress test of 3% to the first five years of a loan to ensure the borrower could cope with rate rises.

Pressure to reduce lenders’ exposure to the risks (in a downturn) associated with high LTV loans has come primarily through the ‘Basel’ guidelines on levels of provision that lenders need to set aside to cover those risks, rather than directly through FSA or FCA regulation. Those requirements, as well as the direct impact of the post-2007 downturn, have seen a very marked reduction in levels of high

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<sup>47</sup> Though there is a current FCA consultation on the guidance on retirement interest-only mortgages.

<sup>48</sup> See Financial Stability Report 41, June 2017 page 25, Table A1 summarising the Bank’s mortgage market tool kit.

LTV loans. Moreover, we may have via 'Basel 3' higher capital weightings for high LTV loans. This will push up the costs of such loans and thus, combined with stress and affordability tests, further reduce both lender appetite for such loans and the numbers of borrowers who can afford them.

Although the FCA would argue that to date there is little evidence to suggest that in combination these regulations have reduced access to mortgages,<sup>49</sup> this would not be the industry view.<sup>50</sup> The sharp decline in the availability of high LTV – or low-deposit – loans, and the government policy response, are discussed further below.

### **Funding and competition**

Since the GFC and historically low Bank base rates since 2009, many lenders have become significantly reliant on special Bank of England funding schemes (and this has also allowed them to reduce savings rates to investors). Reliance on retail deposits and securitisation has thus diminished. Given that some lenders do not have access to such schemes and have been more reliant upon securitisation, it has shifted the competitive balance between lenders, with some now more reliant on lending into higher-risk/higher-return markets. Of course, historically low interest rates have been a major aid to home buyers.

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<sup>49</sup> FCA (2016) *Embedding the Mortgage Market Review: Responsible Lending Review*, Thematic Review TR16/4. London: FCA.

<sup>50</sup> IMLA (2017) *The new 'normal' – prospects for 2017: Is the march back to a sustainable market on track?* London: IMLA, and Pannell, B. (2017) *Macro-prudential regulation: have we got the balance right?* CML News April 21<sup>st</sup>. London: CML.

## 5 Conclusions, context and comment

Researching the relationship between government and the private housing market has highlighted the many and complex relationships that exist. It has also emphasised that we lack the data to give a complete picture.

Notwithstanding these limitations we have produced an overview by bringing together material that is rarely combined. Our primary task was to describe the situation and to comment on how it has evolved. Inevitably this also leads to questions about fairness and efficiency but while we make brief comments this is another subject altogether and a much bigger project.

In this concluding chapter we aim to do two things. First, we go back over the operating context – the way the market is currently functioning and the impacts that the measures covered in the report are making. Second, we draw together some of the key findings from the report on the overall financial costs and benefits related to homeownership and the private rented sector, offering what in reality is a flawed but still useful assessment of how that plays out on a tenure-by-tenure basis.

### Operating context

Affordability across all tenures remains an ongoing issue. This is especially true with respect to homeownership and is particularly acute in London, and in a number of other areas with relatively high house prices. But the extent of current homeowner affordability constraints across the UK can be exaggerated. This is partly because of excessive media preoccupation with London and very high-price areas. It is also partly because many house-price data series have exaggerated the increase in prices since 2008, partly because most measures focus on individual earnings rather than household earnings (when a high proportion of first-time buyers are dual-income couples) and partly due to a continuing focus on house-price-to-income ratios that take no account of the much lower mortgage interest rates that have prevailed in recent years.

Figure 16 below, based on Nationwide ‘mix-adjusted’ first-time buyer house prices, enables us to make two points. One is that measures of house prices and mortgage costs as a proportion of earnings are much lower when taking account household rather than individual earnings. The second is that while house-price-to-income ratios are now a little higher than in 2007, much of that rise has been supported by a continuing fall in mortgage interest rates – from 6.1% in 2007 to just 2.3% in 2016.<sup>51</sup> When that is taken into account it can be seen that mortgage costs for first-time buyers have continued to ease back since 2007, and now represent just 14% of average working-household incomes.<sup>52</sup> While this is still rather higher than the prevailing levels in the decade to 2003, it is well below the levels at the recent peak of the market in 2007.

Within that wider picture it should also be recognised that there are regions and local areas within the UK where house-price-to-earnings ratios, as well as mortgage-cost-to-earnings ratios, remain

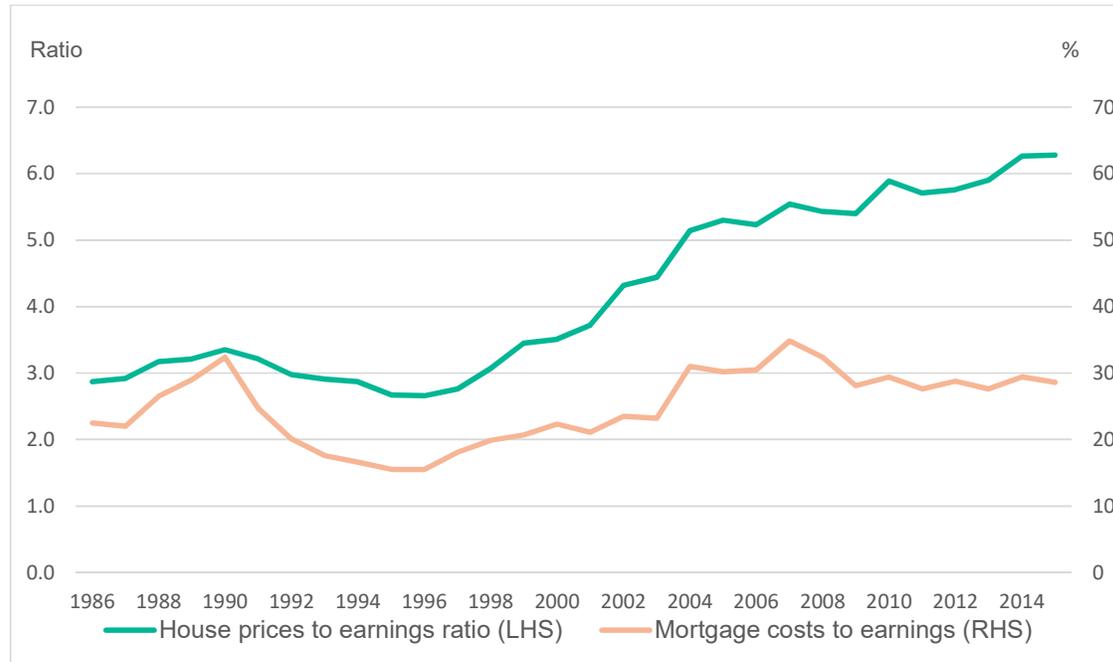
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<sup>51</sup> UK Finance statistics on average interest rates for new mortgage advances.

<sup>52</sup> Household earnings data commissioned from the *Living Costs and Food survey*.

lower than in 2007. Indeed, the same analysis shows that it is only in the southern regions of England (and especially London) that house-price-to-earnings ratios are higher than in 2007; in all other parts of the UK they are lower.

**Figure 16: Housing market affordability in the UK, 1991 to 2016**



Source: RMS first-time buyer house prices; ASHE earnings (adjusted for changes in methodology).

If the affordability constraints on access to homeownership (outside London) can be exaggerated, it is also the case that the tax reliefs discussed above (CGT relief and the absence of a use-value tax) serve to inflate house prices, and thus raise the entry costs for first-time buyers. Those tax reliefs also indirectly contribute to an element of the affordability constraints on entrance to the sector.

A second factor to consider is the ability of households to secure a mortgage, and to cover the costs of a deposit, and the other initial costs of homeownership. As discussed earlier, the government's Help to Buy policies have had some impact in improving the availability of low-deposit mortgages. Nonetheless it remains the case that, even with the support of Help to Buy, would-be first-time buyers face a 'deposit barrier' to homeownership greater than the generation of households that entered the sector over the two and a half decades to 2008. This may be mitigated to a degree by the new Lifetime ISA, however there are questions both about how effective that measure will be and about its cost effectiveness when compared to alternative policy options.

It can be argued that the ISA provisions aimed at boosting savings and helping generate bigger deposits reflect a settled policy presumption that mortgages requiring less than a 5% deposit are inherently more risky, both to lenders and borrowers. Now clearly purchases with very small deposits provide less of an equity cushion if the purchaser runs into difficulties, and there is a greater risk of falling into negative equity in the event of a market downturn, and these are issues for both lenders and borrowers.

Nonetheless the evidence from the FSA Mortgage Market Review was that while advances requiring a deposit of less than 10% were slightly more risky than those with higher deposits, it was only advances made without *any* requirement for a deposit that led to significantly higher default rates (5.8%). Indeed, advances with a deposit of less than 5% (but greater than 0%) were seen to be slightly *less* at risk of default than those with a deposit of 5-10%. This evidence clearly challenges the current policy presumption against supporting mortgages requiring something less than a 5% deposit.

The raising of the 'nil rate' threshold to £300,000 for stamp duty for first-time buyers on purchases of dwellings valued up to £500,000 has, however, reduced the total up-front capital funds required for households to become first-time buyers (by up to £3,500).

A third factor constraining household aspirations to become homeowners is the competitive advantage in the market place held by buy to let investors. It is only over the last two decades that BtL mortgages have been available at competitive interest rates. A particular feature of the mortgages, noted earlier, is that they typically only require a commitment to interest-only payments (though typically with a lower LTV), with no immediate requirement for any repayments of the capital element of the loan and a less demanding affordability test. In contrast post-2007, and reinforced by the MMR, repayment mortgages – requiring both a regular interest and capital element – have become the standard for first-time buyers. For them, interest-only mortgages with no accompanying capital repayment vehicle, are now exceptional (albeit currently increasing from a very low level). In the context of the prevailing low levels of interest rates, the differential costs of an interest-only and repayment mortgage are very substantial. For example, a £100,000 mortgage with interest rates at 2.5% requires an interest-only monthly payment of just over £208. A standard 25-year repayment mortgage would require a monthly payment of £453, more than double the cost.

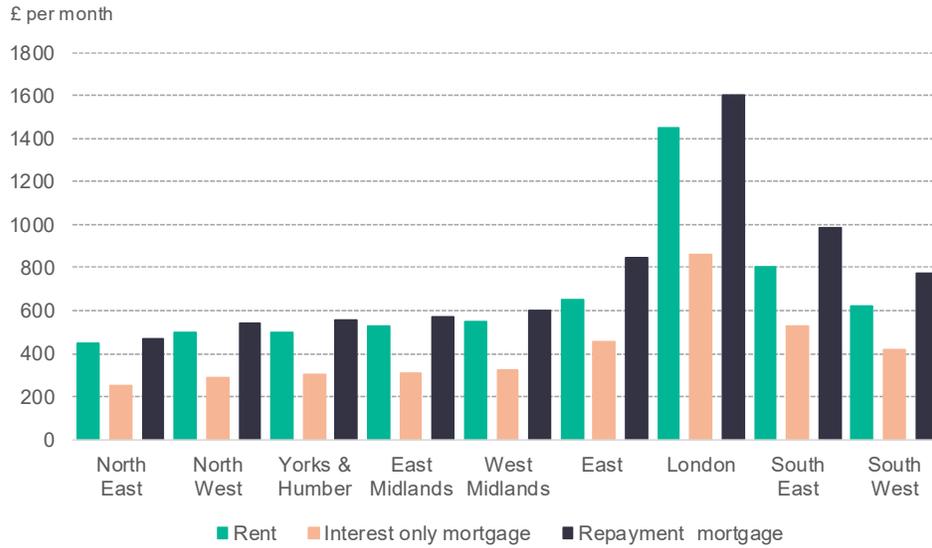
When the costs of these alternative mortgages are set against median regional house prices for two-bed dwellings in 2015, and compared to average market rents for properties of the same size, it is apparent that the mortgage costs for a homeowner are somewhat higher than average market rents (except in the North East and North West of England), and very substantially higher than the cost of an interest-only mortgage (see Figure 17 below).

In contrast, from the perspective of a buy to let investor not only are the debt-service costs associated with purchase significantly lower than for first-time buyers, they are also significantly lower than average market rents, providing a sizeable margin to cover management and maintenance costs and the interest-rate margins required by BtL lenders

While significant, it should also be noted that BtL mortgages only represent a modest proportion of the total level of investment in the private rented sector, with much of the investment being based on the capital resources that investors are able to bring to the sector.

It is this overall competitive market advantage that investors have, based on both access to interest-only mortgages and capital resources, that has been both a key factor underpinning the rapid growth of the private rented sector and that subsequently prompted the SDLT and income tax changes for private landlords outlined above, as well as the SDLT reductions for first-time buyers announced in the November 2017 Budget.

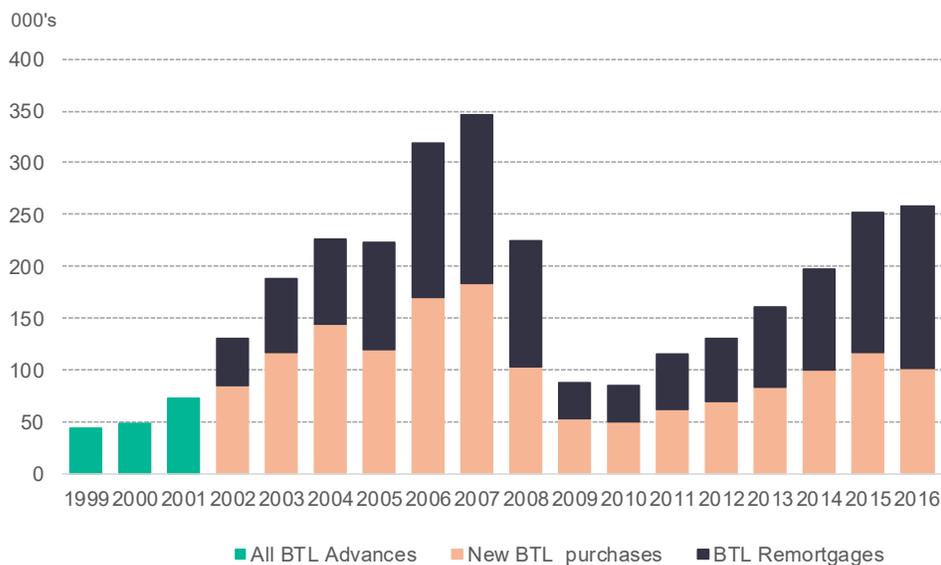
**Figure 17: Rents below purchase costs by English region, 2016**



Source: ONS House Prices; VoA Rents 2014.  
Note: Median prices for two-bed dwellings.

If those tax changes are rather ad hoc, it remains to be seen what impact they will have on the relative prospects for private renting and homeownership in future. In the short term, the numbers of BtL advances for house purchase tripled in the month of March 2016 to over 29,000, ahead of the SDLT changes. However, following a short-term dip in April 2016, they have since then been running at around 6,000 a month (up to the end of 2017).

**Figure 18: New buy to let mortgages, 1999 to 2016**



Source: UK Finance.

If this trend continues, by the end of 2018 this will see new investment falling back to around two-thirds of the level in 2016, and back to levels only a little higher than in the years in the immediate aftermath of the 2008 market collapse (see Figure 18 above). But given that the 2017 income tax changes have not long been introduced, it is too early to make a full assessment of how private landlords will react further ahead, as the impact on their tax position begins to be felt.

### Comment

We have worked through the main areas of spending and taxation related to the private housing market and added in a smaller, contextual comment on spending in the social housing sector and on regulation. What is very clear from our discussion of the total impact of residential property taxation is that in net terms (taking tax reliefs away from tax paid) the homeownership sector's tax position benefits to the tune of more than £29 billion a year, plus as we showed in Table 1 it also now receives more than £5 billion of government support per annum, albeit much of this in the form of loans and guarantees.<sup>53</sup> This highlights the complexity of arriving at final figures of the overall position by tenure – like-for-like comparisons are very difficult. By contrast the private rented sector pays more than £8-9 billion per year to government through the tax system. It then currently gets back less than £1 billion in terms of funding support for development in the form of loans and guarantees and is also in receipt of around £9 billion annually in terms of housing benefit payments.

Overall, this suggests that in very crude terms the private rented sector is currently in a financially neutral position; but the ending of the PRS guarantee scheme and the new taxes introduced now sees the balance tipped so that the sector becomes a net contributor. In contrast the homeownership sector is ahead by around £34 billion per year – again in very crude terms and lumping all types of funding together.

This highlights the very heavy emphasis on supporting homeownership. Within that there is a clear intergenerational divide, with the net gains from tax reliefs largely accruing to older and longer-established owners, while the equity loans and other policy measures are primarily focused on younger first-time buyers. In one sense these different strands of financial support might be said to cancel each other out, even if their costs to government are cumulative.

These two private sector comparisons are instructive. So too is the comparison with the social rented sector where the position is equally complex. If only housing benefit, and support for social sector housing investment, are counted then the subsidy currently amounts to some £20 billion per annum. However, if housing association borrowing (currently being counted as public expenditure) and the economic subsidy from sub-economic rents are added in, then the total rises a good way towards a subsidy of £30 billion per annum.

Thus in terms of financial support in the broadest sense the private sector is getting close to £38 billion per annum in contrast to the public sector – social housing – getting around £30 billion.

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<sup>53</sup> See Table 1. The £5 (+) billion per annum figure excludes the support provided to the private rented sector, and the support to promote new housing building that is not tenure-specific.

Homeownership specifically is the most subsidised sector but as we have stressed this is using a very broad definition of what counts as spending.

As will be evident this report has outlined the many and varied government policies as well as tax and regulatory arrangements, that apply to private sector housing in particular, in the UK. It has shown how, despite the growing role that government is playing, especially post-2007, we have still seen an absolute and proportional decline in the homeowner sector.

While the full impacts of the recent changes to the tax arrangements for private landlords and first-time buyers are yet to be felt, there is little doubt that the PRS will continue to grow; albeit with considerable uncertainty about the extent to which the tax changes will slow the rate of growth. Similarly, it remains to be seen whether the reforms will be sufficient to halt, or even begin to reverse, the proportional decline in homeownership.

In the long run, continuing growth of the private rented sector will impose costs on government in the form of higher housing benefit costs, especially in relation to the growing numbers of retired households that will be private renters rather than homeowners. For example, given the long-term trend towards homeownership settling at around 60%, and assuming no percentage growth in the social rented sector, this could readily lead to a tripling in the numbers of retired households in the private rented sector in receipt of housing benefit and a cost to government (at current values) of some £3 billion or more a year. While this figure is illustrative, it serves to make the point that the continuation of current trends is not a cost-neutral option for government.

While mindful of those potential costs to government the primary issue is the extent to which the current policy, tax and regulatory regimes are driving these shifts and are failing to meet household aspirations, or to enable private sector housing market suppliers to respond fully to those aspirations. At present many of the homeownership subsidies are demand-based, i.e. they help purchasers and this in turn is assumed to feed through into more supply.

The Prime Minister tells us we have a 'broken housing market' and that the principal solution is more supply. While more supply is certainly a necessary element, it is almost certainly not in itself sufficient, as this review has demonstrated with respect to the ways in which government supports housing provision. The current subsidy and taxation arrangements undermine balance in the housing market, distorting costs and choices. While this is a long-standing situation and reflects political pressures, there are questions as to whether we are spending as efficiently as we can in the housing sector, a pertinent point given the general pressure on public finances.

It is not appropriate here to make the case for specific reforms. In 2013 the Institute of Fiscal Studies published the Mirrlees review of taxation<sup>54</sup> which gave considerable attention to the reform of property taxes. Together, the Mirrlees and the Lyons reviews clearly identified the weaknesses in the taxes applied to residential property. They argued for tax arrangements more coherently related to the full economic use-value of residential housing, and to the capital gains that arise from

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<sup>54</sup> Mirrlees, J. *et al* (2011) *Tax by design*. Oxford: Oxford University Press. Aside from arguing for it to be progressive, neutral and efficient it was suggested that stamp duty should be abolished and council tax reformed so that payments are fully proportional to house value and are based on up-to-date values.

property ownership. Those findings have recently been reinforced by two reports on council tax and stamp duty for the London Finance Commission.<sup>55</sup> In brief, the taxes we do not levy are seen as more appropriate, while the taxes we do levy are seen to be heavily flawed.

We are constantly warned away from such reforms. However, while recognising that tax reform is politically difficult, it is not impossible. It does however require overcoming a number of challenges. First, because tax reform needs to be implemented over the longer term, it requires cross-party agreement. Second, it should be introduced in ways which are sensitive to the economic and interest-rate cycle so that households can be benefitting from increased earnings alongside any increased taxation/reduced tax deductions. Third, it should be sensitive to the diversity of markets across the UK.

Given our review we would question whether the government is using its resources to best effect. In recent years we have seen a move away from direct grant funding towards equity investment loans and guarantees which may or may not be called upon or repaid. In principle this has in our view been a sensible development, recognising the capacity of government to do far more than simply pay directly for specific services. However, there are still opportunity costs associated with the choices government makes and though a cost-benefit analysis is now undertaken for most policies this typically does not look across spending areas to see if the same resource might be better used elsewhere.

We have highlighted the growing 'expenditure' related to Help to Buy in terms of the Help to Buy ISA, Lifetime ISA and Help to Buy equity loan, as examples of demand-led subsidies which aim to help overcome housing supply deficiencies. There are, however, pertinent questions both about whether those measures could be better targeted, and whether other policies might be more effective (and cost-effective) in overcoming the 'deposit gap' and boosting the supply of new housing (e.g. perhaps re-introducing a low-cost government guarantee on high LTV loans).

If any cost-benefit analysis remains complex and open to challenge, the accounting for Help to Buy is difficult and far from transparent. The very scale of the interventions and the apparent ease with which they can be increased and extended raise major questions as to how they can be terminated without damaging the very markets they are helping to underpin. Unwinding Help to Buy seems to be a far bigger challenge than initiating it in the first place.

As we showed in Table 1, the balance between grants, loans and guarantees has altered with the last two becoming far more significant over time. This leaves open the question of what is the most cost-effective and fairest way to support housing supply. We have had the long-running debate about support for property versus support for people – the former locking subsidy into particular homes, the latter means-tested and going via the household. Over time the balance of spending has moved towards the latter as government shifted away from direct funding, not least in social housing. However, as we have seen with the policy changes on housing benefit and universal credit, revenue

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<sup>55</sup> Christie, E. (2017), *Stamp Duty in London: A publication for the London Finance Commission*. London: GLA Economics. Also see footnote 27 on page 25.

funding of this kind is very vulnerable to cut backs, altering the economics of the sectors where such subsidies flow.

Similarly, while loans and not least equity loans make considerable sense we do need to note the risk transfer to government from households (and indirectly to lenders) in terms of exposure to house-price inflation and the costs of repaying loans. As this suggests, all methods of support have their strengths and weaknesses – we need to be aware of what they are and plan accordingly.

The UK housing market remains volatile by international standards and this volatility over the economic cycle then makes it harder for builders (and to a degree lenders) to invest in new technology, better-trained staff and much else. The stop-start nature of this cycle makes the supply response weaker, with all the consequences that flow from this.

The government has now recognised the limits of what can be achieved by the speculative housebuilding industry and it is moving to diversify the supply chain. This will have consequences for lenders who will need to be ready to offer mortgages on homes produced by a more diverse array of producers, including housing associations, local authorities, self-build schemes, co-housing and community land trusts, as well as using a variety of technologies. We can expect to see more shared ownership, rent to buy and other products which are outside what some would see as the more mainstream areas of mortgage lending.

To assist lenders, builders and indeed the market, and in the long run to help itself, government must address the question of market volatility and look to see how it can better smooth the cycle with less disruption to all the parties involved. That remains one of the large gaps in the debate on the ‘broken housing market’.

## Appendix: The homeownership safety net

Intervention	Department	Introduced	Description of intervention
Mortgage rescue scheme	MHCLG	January 2009	Aimed at preventing repossession of only the most vulnerable households that would be accepted as statutory homeless.
Repossession prevention fund		April 2009	A £20 million fund for local authorities to implement discretionary measures to protect vulnerable households from the immediate threat of repossession at a maximum of £5,000 per household.
Homeowner mortgage support scheme		April 2009	Available to households experiencing an 'income shock' but not eligible for other sources of help. Designed to facilitate a temporary reduction in mortgage payments for a maximum of two years until income is restored with the balance payable on deferred terms. Intended to help up to 42,000 households, but take-up was limited. The scheme closed as planned in April 2011.
Enhanced court desk service		April 2008	Ensured availability of free legal advice and representation across the country for people facing possession action in the courts.
Enhanced support for mortgage interest	DWP	January 2009	A part of the overall benefit entitlement for around 223,000 claimants in receipt of certain benefits. Enhancements temporarily froze the payment rate at 6.08 per cent, reduced the waiting period to 13 weeks and raised the mortgage cap to £200,000. The payment rate was changed in October 2010 to 3.63 per cent based on the Bank of England published average mortgage rate. The enhancements to the waiting period and the mortgage cap are funded to January 2013.
Mortgage pre-action protocol	Ministry of Justice	November 2008	Sets out guidance from the judiciary on the steps that lenders are expected to take before bringing a possession claim in the courts with the aim of ensuring that repossessions are a last resort.
Regulation of sale and rent back market	Financial Services Authority	June 2010	Following a report by the Office of Fair Trading in October 2008, the Financial Services Authority has consulted on and introduced regulations that firms offering sale and rent back have to adhere to.

Source: NAO (2011) *Department for Communities and Local Government; The Mortgage Rescue Scheme*. Report by The Comptroller And Auditor General HC 1030 Session 2010–2012, 25 May 2011. London: National Audit Office.



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