House prices in Great Britain

By Adrian Coles

ALMOST two-thirds of the housing stock in Britain is owner-occupied, about 25% is rented from local authorities, 7% is rented from private landlords and 3% is rented from social housing agencies called housing associations. Owner-occupation has been rising rapidly. At the end of the second world war probably no more than one-third of all dwellings were owner-occupied, but this figure rose to 50% by 1970, to 60% in the early 1980s and currently stands at 66%. In contrast, the importance of rented housing has declined.

There have been a number of factors influencing the growth of owner-occupation:

(a) The private rented sector, which until the mid-1980s accounted for more than half of all dwellings, has been heavily regulated. In particular, the Rent Acts, which were introduced as a “temporary” measure in 1915, have held rents at a level that has not offered an attractive return to those minded to offer rented accommodation. Also, tenants have had security of tenure and most landlords have felt that it would not be easy to evict tenants for non-payment of rent or other breaches of the rental agreement. Until 1988, rents were fixed by a rent officer at “fair rent” levels. The rent officer was supposed to take into account the quality of the accommodation offered, but not its relative scarcity. For anyone familiar with the simple theories of supply and demand this is nonsensical. The price of every good is determined by the number of units in supply when compared to the number of units demanded, and yet British legislation asked rent officers to ignore these factors.

(b) The demand for owner-occupied dwellings has been boosted by favourable tax arrangements. The interest paid on mortgage loans up to £30,000 is eligible for tax relief so that in effect, if the mortgage rate stands at 14%, the borrower pays just 10.5% on the first £30,000 of his loan if the rate of tax is 25%, the Government paying to the lender the 3.5% not paid by the borrower. Indeed, tax relief is available at the borrower’s highest marginal rate, and if he pays tax at the top rate of 40% then his mortgage will cost him only 8.4%. The importance of mortgage tax relief has been declining in recent years. Nevertheless, throughout the 1960s, 1970s and early 1980s it was a powerful factor encouraging people to buy their own homes.

(c) If borrowers become unemployed, the Government will pay their mortgage interest indefinitely. This Income Support, as it is known, is payable to households with incomes below a certain level and which have no more than fairly modest savings. As explained later, it can be seen as being at the centre of a system that helps prevent house prices in Great Britain falling.

(d) The sale of council houses. Between the 1950s and 1970s owner-occupation and council housing grew together, and by the end of the 1970s council houses accounted for over 30% of the total stock of dwellings. Council house rents were subsidised and there was always a waiting list for such housing, which tended to be allocated on local councils’ perceptions of needs. Thus the poor, the elderly and families with children tended to be allocated housing by councils, whereas young single people and those with higher incomes were unable to obtain such accommodation. One of the most radical shifts in housing policy this century occurred with the Housing Act 1980 which was implemented soon after Mrs Thatcher’s period of office as Prime Minister began. This legislation introduced what is known as the “Right to Buy”, which meant that local authority tenants were able to
purchase their houses at heavily discounted prices. The current arrangements mean that some tenants can purchase their dwellings at a discount of 70% to the free market valuation. Around 1.3 million dwellings have been sold since 1980, and this has been a major factor to explaining the growth of owner-occupation during the 1980s among the middle aged and elderly, and among lower-income groups.

The mortgage market
Until the early 1980s, building societies — mutual savings banks whose sole function was to collect small individual deposits, and turn such deposits into loans to help people buy their own homes — monopolised the mortgage market. Other institutions effectively were not allowed to offer mortgage finance, and building societies operated a cartel, agreeing among themselves what rates of interest to pay to investors and charge to borrowers, therefore determining their own profit margins.

The cartel very often set the mortgage rate below a market clearing level, and there were often queues for mortgages, which made it fairly easy to run a building society. There was relatively little innovation and little attention had to be paid to standards of customer service.

During its early years the Thatcher administration abolished the restriction that prevented other institutions offering mortgage loans. Between 1980 and 1982 the commercial banks increased their market share of new lending from 5% to 36%, and many of the restrictions that building societies had previously imposed, such as having to hold a savings account with a society before being eligible for a mortgage loan, and having to wait for quite a lengthy period between the application for a loan and actually receiving it, were abolished. The commercial banks now have about 20-25% of the market.

New institutions have also been established which typically obtain their funds from wholesale sources and distribute their loans through financial intermediaries, that is individuals whose job it is to advise members of the public about their financial affairs. In recent years innovation has been rapid, and there are now many different types of mortgage finance available.

Despite this innovation, 99% of all mortgage finance in the United Kingdom is still based on variable interest rates, whereby the rate of interest on the loan can be changed after the lender and borrower have signed the loan agreement. Over the past 18 months UK mortgage rates have risen from 9.5% to 14.5%, an increase of around 40%, and in recent years rates have changed about once every three or four months. This obviously has an effect on house prices, although the effect is somewhat less than if mortgage rates were fixed for the term of the loan.

Mortgage loans are available for up to 95% of the purchase price, and, in many cases, for first-time buyers up to 100%. The top 25% of a loan is insured so that if house prices do fall (which is very rare), a lender would not record a loss unless the price falls by more than 25%. Typically, loans of up to three times annual gross income are available, plus once the secondary salary. Thus someone earning £15,000 a year, whose spouse earns £10,000 a year, would be able to borrow £55,000. Perhaps surprisingly, generally these multiples do not change according to the level of interest rates.

Around four-fifths of all new borrowers choose to repay their

HOUSING FINANCE INTERNATIONAL FEBRUARY 1990

21
mortgages by the endowment method, i.e. they make payments of interest only to the lender and simultaneously pay premiums to an insurance company on a 25-year endowment policy. At the end of the 25-year period the loan is repaid in a lump sum from the proceeds of the maturing policy. Usually the insurance company pays out a sum significantly in excess of that required to pay off the loan outstanding so that the borrower himself receives a lump sum.

One other distinguishing feature of the UK market is that people tend to buy their first houses at a very young age. Around 35% of under 25-year-olds are owner-occupiers, a much higher proportion than in most other industrialised countries. The lack of rented accommodation and the allocation of the rented accommodation that is available on the basis of needs means that people have little choice but to become owner-occupiers, even if in their younger years, when they are moving from job to job and area to area, renting would be appropriate.

Home owners tend to stay a relatively short period in their first and second homes, but trade up rapidly using the profits from the first home to make their deposit on their second home, so that by the age of 40 perhaps they have the house that they would actually like to live in.

Trends in house prices

House prices have risen rapidly in recent years — the average rate is 15% per annum since 1970, compared to a 10% per annum growth in consumer prices. The price of housing is a constant dinner party conversation piece. With most households owner-occupiers, and with the house by far the most important asset which the household owns, there is an intense interest in the trend of house prices.

There are many competing house price indices compiled by the major lenders, The Building Societies Association and the Government. Over the short term, these often give conflicting signals. Over the long term there is little disagreement with the view that housing has proved to be the most rewarding asset for any individual to hold over the past 20 or so years.

House price inflation has not, however, run an even course, but rather has been extremely variable. In 1972/73, 1978/79 and 1987/88 house prices rose by over 30% a year, whilst in the mid-1970s, the early 1980s and in 1988, house prices hardly moved at all. House price inflation has been much more variable than the general level of inflation in the economy. In 1988, for example, prices rose by about 35% of other factors that can vary greatly over a short period of time.

The major long-term factor affecting the demand for housing is the growth in the number of households. In the United Kingdom the number of households has been rising much more rapidly than the population as a whole, mainly because there is an increase in the proportion of single person households, which are mostly elderly. During the 1980s the number of households rose by about 100,000 a year, but, 150,000 a year, but around the late 1990s this figure will fall to 95,000 a year, reflecting the one-third decline in the birth rate that occurred between 1964 and 1977.

As an aside it is interesting to note that this massive fall in the birth rate has caused a number of problems in Great Britain. During the late 1970s and early 1980s the demand for primary schooling fell to its lowest level for many years and currently there are not enough children to fill all the available places in secondary schools. Many observers are talking about a demographic time bomb as the demand for school leavers by employers is expected to rise far above the number of school leavers available for employment.

The main effect on the housing market is that the number of first-time buyers is expected to decline rapidly. Indeed, the number of young married households under the age of 30 is expected to halve between now and the end of the century.

In the shorter term, however, it is economic factors that have the greatest impact on house prices.

It is interesting to observe the most recent house price cycle. In the early 1980s interest rates rose to extremely high levels and the UK suffered its most serious post-war recession, with output dropping in 1981 and 1982. Unemployment rapidly rose from less than one million to more than three million individuals, out of a labour force of about 25 million. In these circum-

'Demographic time bomb'

whereas the general rate of inflation was no more than 6%. The reasons for this variability have been intensively researched by a number of institutions and form the basis of newspaper articles virtually every day of the week.

The theory of house price determination

The price of houses is determined like the price of every other product — by the interaction of supply and demand. In the United Kingdom the supply of housing is relatively fixed in the short term. There are about 15 million owner-occupied dwellings, but there are no more than 200,000 new dwellings built each year with perhaps 100-150,000 being transferred from the local authority rented sector under the right to buy legislation. The maximum annual rate of increase in the stock of owner-occupied dwellings is therefore no more than 2%; on the other hand, on the demand side there are a number
BRITISH HOUSE PRICES

stances confidence was low, many fewer people than normal were able to afford to enter the housing market and house prices remained static.

During the middle 1980s interest rates gradually declined and the economy began to recover. In 1986 unemployment began to fall and, indeed, fell every month for over three years. Real personal disposable incomes (a measure of individual incomes which takes account both of inflation and changes in direct taxation) began to grow rapidly from 1986 onwards. Indeed, between 1986 and 1988 real incomes rose by around 8%, historically an extremely rapid rate of growth for a two-year period. Moreover, by the spring of 1988 interest rates had fallen to their lowest level for 10 years.

In these circumstances confidence grew rapidly and as house price inflation began to accelerate the market began to feed on itself. A perverse relationship developed whereby each increase in house prices resulted in an increase in demand as people felt they had to get into the market before the next increase in prices. The Government added to the feeling of well-being by announcing in the spring of 1988 that the basic rate of income tax would be cut from 27% to 25%, with higher rates being cut from a maximum of 60% to a single higher rate of 40%.

Finally, the Government made matters worse by also announcing that an important tax concession would be removed from the end of July 1988. Briefly, previously two unmarried individuals sharing a house were each able to claim tax relief on loans of £30,000; however, the Government announced that from 1 August only one loan of £30,000 per residence would be eligible for tax relief. However, loans which had been arranged or were in existence by 1 August would not be affected by the change. This led large numbers of unmarried couples to enter the housing market at almost any price in order to take advantage of the old tax regulations. During the first six months of 1988 prices in some regions rose at an annual rate of over 50%.

The situation changed rapidly during the second half of the year. It was clear that the rate of growth of the economy could not be sustained. The general rate of inflation began to turn upwards, the balance of payments situation deteriorated, the exchange rate declined, and the Government was forced to increase interest rates. At the beginning of August mortgage rates were increased and this coincided with the change in the tax relief rule. The amount of business undertaken in the housing market dropped rapidly. Further increases in market interest rates, and therefore in mortgage rates, were implemented at the beginning of October 1988 and in January and November 1989.

The outlook for the economy is now far less attractive — the rate of growth of output has declined, the rate of decline of unemployment has slowed, real income growth has fallen, and the number of new houses built in 1989 was down by 25% on 1988. A further 20% fall in private housing starts is expected in 1990. In some regions house prices fell during 1989 and prices for the country as a whole were no more than 5% higher than at the end of 1988.

Regional differences in house prices

There are immense regional differences in house prices in Great Britain. House prices in London are around three times those in Northern

Most in the UK want to be home owners.
England, with the two regions only 300 kilometres apart. There are also immense differences in house price inflation rates so that it is quite possible for house prices to be rising 30% a year in one part of the country while remaining static in another part.

House price cycles begin in London and South-East England. In the current cycle prices were rising rapidly in this region by the end of 1986. During 1987 prices began to rise rapidly in East Anglia and the South-West, which are the regions bordering London and the South-East, while in 1988 inflation began to take off in the Midlands. 1989 saw a more rapid rate of growth in the northern counties of England and in the more remote regions of Scotland and Wales. For the past 12 months

'Wide regional variations'

house prices in these regions have risen much more rapidly than in London and the South-East. Over a long period of time there is little difference in house price inflation rates, but there is evidence to suggest that house price inflation tends to be more volatile in London and the South-East and much steadier in the areas distant from the capital.

There is also evidence to suggest that the pressure on house prices in London and the South-East is intensifying, and that the margin between prices in this area and in other parts of the country may be widening. London is a much more prosperous region than most parts of the country. Unemployment in London is about half of the rate experienced in northern England, incomes are perhaps a third to a half higher, and virtually all major political decision-making is centred on London. London and the South-East is also physically closest to the markets of Europe and this proximity will become more important when the Channel Tunnel is completed in 1993.

The transport system is also more highly-developed in London and the South-East, while the financial system (which tends to pay the highest salaries) is also centred on the South-East (with the notable exception of building societies, many of which have head offices located in the Midlands and north of England).

All of these factors are putting intense pressure on house prices in London and the South-East. There are a number of huge housing developments in the previously derelict dockland region to the east of London, but nevertheless there is a general shortage of land for housing. Land for housing is the ground over which a major environmental battle is being fought. Although only 11% of the land in Great Britain is built upon, there is a feeling among many that urban development is going too far and that building should be restricted. On the other hand, the pressure of demand for housing in the South-East means that there is a great demand for land from house builders and when these two forces come into conflict there are major political decisions to be taken. Everybody agrees that there should be additional housing built, but not close to where they live.

The outlook for regional differentials in house prices is therefore a little confusing. What appears to be the increasing concentration of economic development in London and the South-East, combined with a protective policy towards the environment that is preventing housing development, is resulting in prices in London and the South-East rising compared to the rest of the country. However, in recent years a number of companies have moved their headquarters from London to cheaper parts of the country to take advantage of lower office and housing costs. It is unclear to what extent prices in London will need to rise before a more even distribution of economic development throughout the United Kingdom is achieved.

The future course of house prices

The housing market in Britain is changing rapidly, mainly because of the important changes in Government policy over the past few years. The general thrust of these changes has been to reduce the attractiveness of owner-occupation compared with other tenures, although the Government has gone about this policy in a particularly careful way, not wishing to lose the votes of those in the majority tenure:

The major changes have been —
(a) The retention of the £30,000 tax relief limit. Until 1974, tax relief was available on the interest paid on all mortgage loans whatever their size. In that year the £25,000 limit for loans eligible was introduced and this was increased to £30,000 in 1983. However, the rate of house price inflation has been such that while in 1983 the vast majority of mortgage debt outstanding was eligible for tax relief, by 1989 a large proportion of borrowers were in the situation that an increase in the size of their mortgage did not result in additional tax relief because their mortgage was over the £30,000 limit. In addition, as noted earlier, the Government has clamped down on the rules for people sharing houses and in April 1988, also, tax relief on new loans to improve homes was disallowed for the first time. It is clearly the Government's intention to cut back on tax relief, although the concept of

'Tax relief under threat'
tax relief itself, attacked by many economists and other observers of the housing market, is probably safe, at least until there is a change of Government.

(b) At the same time as restricting the availability of tax relief, the Government has attempted to loosen the restrictions on the rented sector. Since January 1989 all new lettings have been outside the former regulations, and rather than rents being set by a rent officer, they are established in the open market following negotiation between the landlord and

Tenant. It is the Government’s hope that private rented accommodation will account for an increasing proportion of the housing stock, in the belief that this will “free up” the economy, making it easier for people to move house at the early stage of their careers, and increasing the availability of rented accommodation to the elderly who perhaps do not wish to have the responsibility of looking after their own dwelling in their later years. The Government has also introduced a special scheme that gives tax relief to those investing in rented housing, and this has perhaps resulted in an additional 10,000 rented dwellings becoming available during the past 18 months or so. The overall impact of the rented housing initiative is expected to be that the supply of rented housing increases. If this materialises there will, for the first time, be an alternative to owner-occupation and this may serve to reduce the rate of

‘Incentives for renting’

house price inflation in the owner-occupied sector.

(c) Changing welfare payments to unemployed mortgage holders. As noted at the beginning of this paper, unemployed mortgage holders with no other source of family income are entitled to have their mortgage interest paid by the Government. Until recently the Government paid all mortgage interest from the date the applicant became unemployed. A minor change was introduced in 1987 so that from that date the Government has paid only half the mortgage interest due for the first 16 weeks of any claim. After that date the entire mortgage interest is paid again indefinitely. This is a fairly minor change, but nevertheless may be an indication of Government thinking in this area, so that further restrictions on the availability of such payments cannot be ruled out. The importance of this scheme in supporting house prices in particular regions should not be underestimated. In towns and villages, where perhaps a coal pit has been closed down and many people have become unemployed simultaneously, the natural market reaction would be for house prices in that locality to decline rapidly as families found increasing difficulties in meeting their mortgage payments, and either put their houses on the market themselves or faced possession proceedings by lenders, who then put the houses on the market. In Great Britain, however, very few houses come on to the market as a result of rapidly rising unemployment because the Government pays the mortgage interest, and there are relatively few possessions. The welfare state provides an effective form of insurance to mortgage lenders by providing a safety net for unemployed mortgage holders, helping them to maintain their payments and also ensuring that house prices do not fall, thus securing mortgage lenders’ asset base. If this situation changes, house prices could become more variable in Great Britain, and mortgage lending a riskier proposition.

While owner-occupied housing probably does not have quite the advantages which it enjoyed a few years ago, there is no doubt that the number of households wishing to enter that tenure will continue to grow in the next few years. A recent market research exercise undertaken by The Building Societies Association showed that over 80% of households saw this as their ideal form of tenure. Nevertheless, the restriction on mortgage interest tax relief and payments of interest to unemployed mortgage holders and the attempts by the Government to increase the attractiveness of providing rented accommodation probably mean that the advantages of owner-occupation will become less clear cut in future years.

‘Most want to buy’

ADRIAN COLES is head of external relations at The Building Societies Association, London, England. The paper is a revised version of a speech given by Mr Coles at a seminar organised by Banco Hipotecario de España at Santander, Spain, in August 1989.