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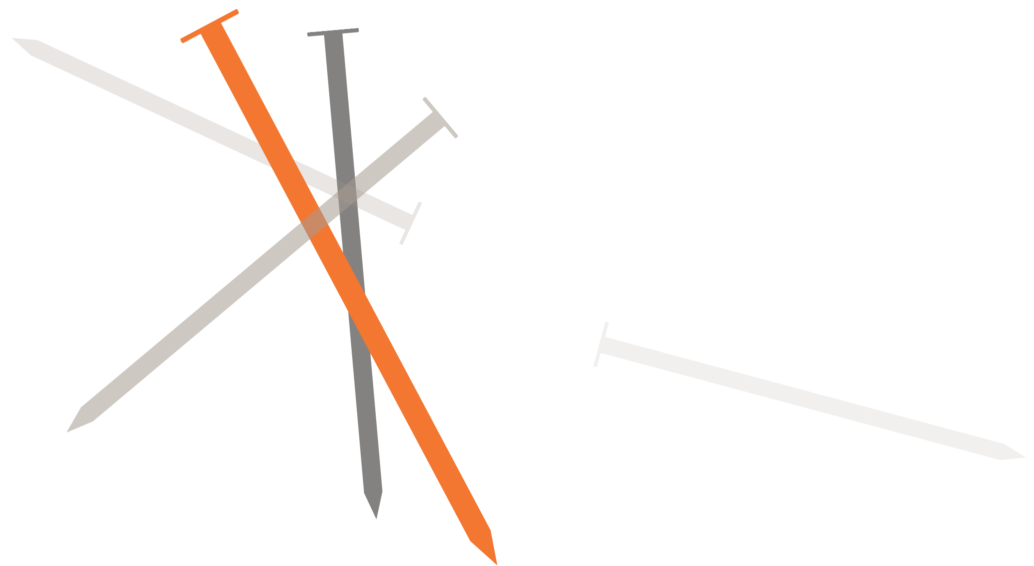

BUILD NOW OR PAY LATER?

FUNDING NEW HOUSING SUPPLY

Andy Hull, Graeme Cooke and Tony Dolphin

October 2011
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SUPPORTED BY

JOSEPH ROWNTREE FOUNDATION

Institute for Public Policy Research

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ACKNOWLEDGMENTS

We wish to thank the many individuals who have contributed to this paper. Andy Hull, Graeme Cooke and Tony Dolphin have written it with advice and assistance from IPPR colleagues Nick Pearce, Dalia Ben-Galim, Jenny Pennington, Tim Finch, Richard Darlington and Beth Keehn.

In particular, we would like to thank Professor Christine Whitehead (professor of housing economics at the London School of Economics), Dr Peter Williams (director of the Cambridge Centre for Housing and Planning Research), Kathleen Kelly (policy and research manager at the Joseph Rowntree Foundation), Duncan Shrubsole (director of policy and external affairs at Crisis), Paul Tennant (chief executive of Orbit Group), Abigail Davies (director of policy and practice at the Chartered Institute of Housing), Sean McLaughlin (director of housing at the London Borough of Islington) and Matt Griffith (founder of Priced Out) for providing such constructive external peer review.

IPPR's research on housing supply is generously sponsored by Orbit Group and the Joseph Rowntree Foundation. IPPR's wider programme of housing research, of which this forms part, is kindly supported by Home Group, Amicus Horizon, Orbit Group, the Residential Landlords Association and the Oak Foundation.

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This paper was first published in October 2011. © 2011
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SMART IDEAS
for CHANGE

CONTENTS

Preface 2

Executive summary 3

1. Context 5

A brief history of housing supply 5

A picture of housing demand 6

The case for increasing housing supply 7

The scale of the challenge 7

Coalition policy on housing supply 8

2. A brief account of some common proposals 11

Increase central government investment in new homes.......................................11

Allow local authorities to build homes with off-balance-sheet borrowing 11

Reform housing associations 11

Continue private sector cross-subsidy of affordable homes....................................12

Release land owned by central government...12

Upscale community-led models 13

Reform tax 14

3. Three promising prospects 15

3.1 Institutional investment in building new homes...15

3.2 The role of local authorities 22

3.3 Recapitalise government spending on housing 25

4. Two other ideas IPPR is exploring 38

4.1 Create a National Investment Bank...38

4.2 Reform the development industry...39

Conclusion 41

References 43

PREFACE

This is the third in IPPR's series of analytical briefing papers as part of its fundamental review of housing policy.[1] We will publish our detailed policy prescription in a final report in early 2012. This paper's explicit focus is how we might finance the supply of new homes. In our first paper, on housing demand, *The Good, The Bad and the Ugly: Housing Demand 2025* (Schmuecker 2011) we projected a significant gap between housing supply and demand, present already and likely to be exacerbated in the years ahead. We believe this conclusion is shared by most policymakers and politicians, across all parties. In our second paper, *Forever Blowing Bubbles?: Housing's Role in the UK Economy* (Dolphin and Griffith 2011) we demonstrated that volatility in the housing market has played a destabilising role in the economy as a whole; that, in order to reduce this negative macroeconomic effect, house prices need to be stabilised; and that, in order to effect this stabilisation, alongside various fiscal and monetary policy interventions and improved credit control, increasing housing supply is vital. So, in this present paper, we turn to a question that is vexing policymakers in government and elsewhere: 'If we are to increase housing supply, how are we to pay for it?'

The paper does not dwell on how better to use the country's existing housing stock – that will be the subject of the next paper in the series – but instead, on how we can afford to increase that stock.

1 See http://www.ippr.org/research-projects/44/7132/housing-policy-a-fundamental-review

EXECUTIVE SUMMARY

Policymakers of all political parties recognise the pressing need for us to build more homes in this country. Today's straitened economic climate makes that challenge a daunting one. This paper, therefore, attempts explicitly and exclusively to suggest ways that we might pay for a much-needed increase in housing supply.

Before addressing that question directly, we present a brief history of past supply and a plausible picture of future demand, showing that, unless we do find a way to finance more new homes, the gulf between demand and supply will grow dangerously wide. Against this backdrop, we briefly outline the powerful economic case for increasing supply. And, having established the scale of the mountain we have to climb, we consider whether current government policy is up to it.

Then, opening our account of possible ways forward, we survey some of the avenues that researchers, policymakers and practitioners have frequently explored. These include: increasing capital investment by central government; changing national accounting procedures to allow local authorities to build more; reforming housing associations; further private sector cross-subsidy of affordable homes; releasing public land held by the central state; upscaling community-led house-building models; and tax reform.

We then focus in on, and further develop, three ideas for financing new housing supply which IPPR considers particularly promising in the current political and economic context:

1. We consider afresh the prospects for institutional investment in residential property in the UK. Our analysis emphasises the prospective investor's perspective. We hone in on the heart of the problem: housing looks low-yield and high-hassle to potential investors. And then we ask if these obstacles are surmountable, concluding that, with careful product design, they may well be for domestic insurance and pension funds. We then argue that it is local authority pension funds that offer the best prospect.
2. Developing our thinking on the role of local authorities, we argue that they should release their public land to developers in return for an equity stake in development; hold auctions to secure private land for new homes; and adopt a 'use it or lose it' approach to privately held land fit for housing, including through the use of more time-limited planning permissions. We suggest also that local authorities need to make the most of the house-building opportunities that housing revenue account (HRA) reform offers.
3. We make the case for the recapitalisation, over time, of government expenditure on housing. We describe the dramatic shift that has occurred over the past 40 years away from capital investment in bricks and mortar towards personal subsidy through housing benefit (HB) and then consider how it might gradually be reversed. We suggest integrating housing policy across government in a single strategy with a single budget, enabling a more deliberate focus on delivering this change. We explore the possibility of introducing a stepped taper to HB and creating a framework for hybrid social-private landlords in order to get more out of the private rented sector, where HB has at times looked like a landlord-enrichment scheme. And we float the idea of localising decision-making responsibility for all housing spend, giving local authorities more of an incentive to keep rents and HB bills down in their area and invest more in new-build.

Finally, we suggest two other possibilities that we think merit further exploration, and on which IPPR is now undertaking further work:

4. We advocate the expansion of the new Green Investment Bank into a fully-fledged National Investment Bank and contend that one of the types of infrastructure it should fund should be new housing. This would mean that the state's resources could be used to enable the private sector to borrow cheaply to build new homes, inverting the operating principles of the private finance initiative. We cite examples of other countries' national investment banks investing in house-building, and argue that we need one of our own to do the same.
5. We urge that serious thought be given to reforming the UK's development industry. Getting land to market is of little use if developers would rather sit on it than develop. We argue we need to find ways of introducing competitive pressures into the industry to incentivise actual development, rather than mere land acquisition.

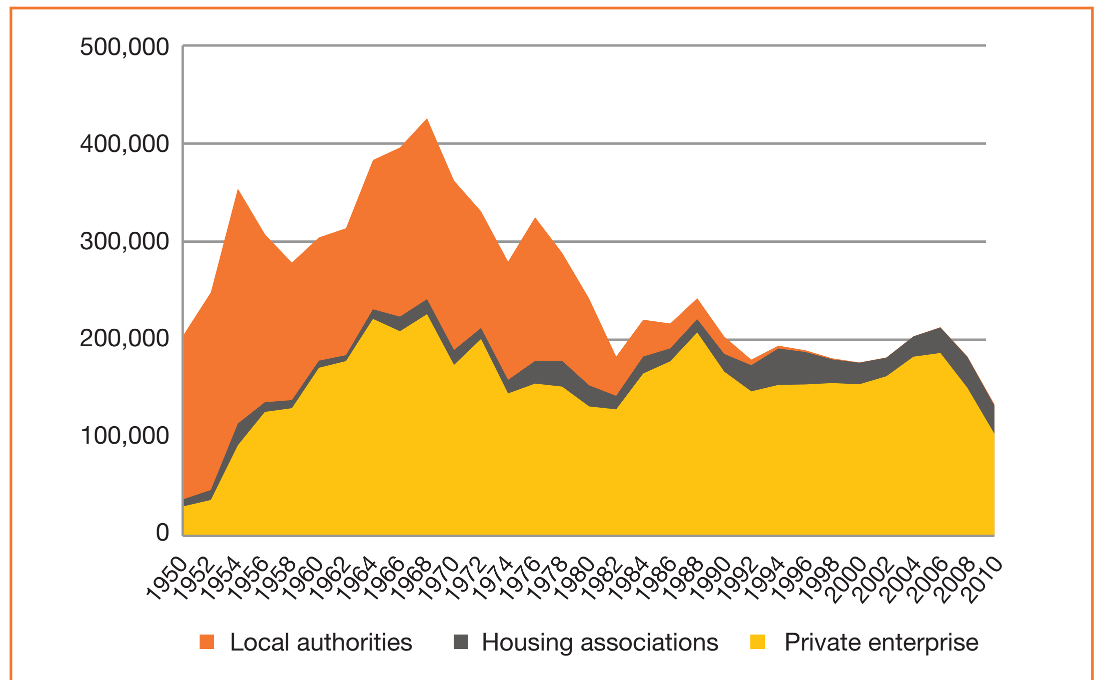
As a country, we are in a 'catch-22' situation, with low growth, low supply, low finance and low confidence, despite low interest rates. There is no one silver bullet when it comes to financing new housing supply. But we hope that the ideas in this paper give the government food for thought for its forthcoming revision of the nation's housing strategy. That strategy must offer more than a recapitulation of what has been done already. And it must not rest too heavily on the single proposition of the release of government land. That can only ever be a small part of the solution to a worsening problem that we cannot afford to ignore.

1. CONTEXT

A brief history of housing supply

Figure 1.1 tells the story of house-building in the UK since the second world war.

Figure 1.1
Permanent dwellings completed, by tenure, UK, 1949–2009

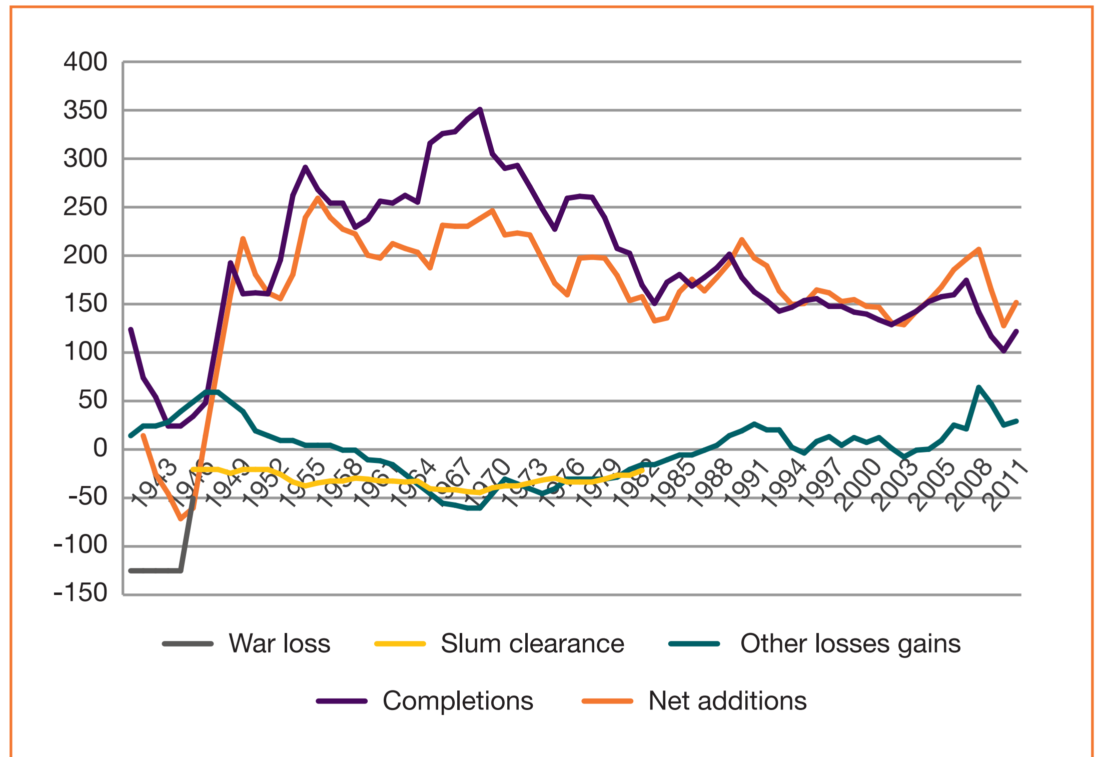


Source: DCLG, Live Table 241

After three decades of high-volume house-building in the wake of the second world war, during which time politicians of all parties competed over how many houses they could build, it has since followed a downward trend. The trajectory of house-building immediately before the recent recession was positive, but still insufficient, and with the crash it dropped sharply. Since the 1980s, local authority house-building has been negligible, and the private sector, which has delivered consistently low output throughout successive booms and slumps, has not made up the shortfall. Affordable housing provision has been left almost entirely to housing associations. Indeed, until the Right to Buy, introduced in 1980, began to run out of steam in the mid-2000s, there had actually been annual net losses nationally in affordable housing supply. Overall, in 2009, there were 118,000 homes completed in England, and in 2010, only 102,570 – the lowest peace-time level for almost a century (DCLG 2011a).

But numbers of completions alone do not give us a full picture of net additions to the national stock. For a fuller picture, we need to factor in losses as well, whether they have come in the form of war losses through bomb damage, slum clearances or demolitions for redevelopment. Conversions and changes of use also need to be taken into account. Figure 1.2 brings together these datasets and includes a forecast for 2011 based on first-quarter and first-half-year data.

Figure 1.2
Housing stock changes in England ('000s)



Source: Housing Futures Ltd

A picture of housing demand

Yet, while house-building is at a record low, demand continues to rise. We predict there will be 4 million additional households in England by 2025 as a result of population growth (for example, through immigration), demographic change (such as an ageing population) and social change (for example, an increasing divorce rate). We expect to see the worst mismatches between supply and demand in the Greater South East, with particular pressure on social housing. Overall, IPPR has estimated that, building on government projections for household growth, provided the economy recovers at a reasonable rate, and assuming we build as many new homes in the next 20 years as we have in the past 20 (that is, on average, 160,000 per year), we will have in England 750,000 fewer homes than we need by 2025[2] (Schmuecker 2011). Despite being one of the richest countries in the world, we are failing to provide enough homes for our people. Owner-occupation is now unaffordable for many, particularly those without access to the 'bank of mum and dad' (a predicament set to be exacerbated by raising the cap on university tuition fees). Social housing is increasingly residualised. And the private rented sector, into which the 'squeezed middle' is being funnelled, remains both unprofessional and insecure. People are rightly asking, 'where are our children going to live?' As a country, we need to provide an answer.

2 This would mean 750,000 fewer homes than would be needed to fulfil the population's housing expectations, as opposed to 750,000 households actually made homeless.

The case for increasing housing supply

Increasing housing supply is, in the end, the only way to achieve what ought to be the primary objective of housing policy: to provide secure, decent, affordable homes for the whole population. Housing is a key determinant of people's life chances. Government, therefore, has an important role to play in ensuring housing need is met, to deliver a more secure future for our children, and to reduce inequality between households and between generations.

The economic case for increased house-building and its contribution to the growth agenda is powerful. Construction makes a significant contribution to the economy (around three per cent of GDP), generating (in 2008) £91 billion of economic output and accounting for over 1.5 million jobs (Shelter 2010). New homes in the right places enhance labour mobility and facilitate local economic growth. Overall, as Shelter and others have shown, for every £1 of public money spent on house-building, the economy gets £3.50 back. The flip side of this is that reduced construction activity will damage national economic output. For every £100 million cut in terms of capital investment in new homes, there will be 2,500 fewer jobs in the construction sector, 1,650 fewer homes, and economic output will fall by £351 million (Shelter 2010). Recognising this, chancellor George Osborne and communities and local government secretary Eric Pickles recently observed that reforming the planning system in favour of a presumption for development 'is our opportunity to unlock the new investment and new jobs the country needs. We cannot afford to miss it' (Pickles and Osborne 2011).

But this 'multiplier effect' (on which housing, as a non-productive asset, scores less favourably than some other forms of infrastructure investment) is not the only economic consideration. Increasing housing supply would also help to ward off negative economic consequences, not least because it is likely, over the long term, to check excessive escalation and volatility in house prices, which IPPR has previously shown are dangerous and damaging to the economy as a whole (Dolphin and Griffith 2011, JRF 2011). Moreover, labour immobility owing to a lack of affordable housing is estimated to cost the economy £542 million per year (Gulliver 2010), even though most job moves do not require a house move and the vast majority of house moves (around 90 per cent) are not job-related (Regeneris Consulting 2010). Increasing supply also stands to reduce the exported costs of inadequate housing, for instance in education, crime and health. The annual costs of poor housing have been estimated at £2.5 billion to health and £1.8 billion to criminal justice, and £14.8 billion is 'the amount of money in lost earnings for the current group of young people going through the school system based purely on differences resulting from the impact of poor housing on their GCSE results' (Friedman 2010).

The scale of the challenge

As a country, we need to build the right number of new homes, not too many and not too few. Over-building, resulting in excess residential property, can be a serious problem, as has been demonstrated in Ireland (see figure 3.2). In 2004, the Barker review recommended a step-change in supply to 240,000 per annum (Barker 2004). In IPPR's view, we now need to be building around 250,000 new homes each year over the course of the next 15 years, and these new homes need to be of the right sort (for our changing household profile) and in the right places (where there are prospects for employment)(Schmuecker 2011). This will be no mean feat, with average house prices currently at around six times average earnings, record low levels of house-building, and (for now, at least) tight mortgage lending. We are in a post-crunch bind of low finance making for low effective demand as well as low supply in a largely dysfunctional market.

Yet, with government investment in social housing unlikely to rise in the short term, the majority of new homes will need to be built by private developers for private buyers to live in or let. A strong sale housing market is therefore necessary, but without a return to the loose lending that helped to inflate the last housing bubble. When it comes to land, planning and lending, policy will need to work carefully with the market to deliver the new homes we need.

Coalition policy on housing supply

In terms of answering this case, and rising to the formidable challenge it poses, we now consider current Coalition government policy and its likely effects on housing supply.

The last government's Housing Green Paper expressed the government's aspiration to see 240,000 new homes built each year by 2016 (DCLG 2007). However, this government has resolved to reduce DCLG's capital budget by 74 per cent in cumulative terms over four years (Lloyd 2010), reducing by 63 per cent government investment in affordable housing (Lloyd 2011) which is likely to lead directly to a reduction in the number of new homes delivered. In order to see more new homes built, despite this drastic reduction in public spending, the government has introduced a number of other policy reforms.

First, as part of this package, the £900-million New Homes Bonus (NHB) scheme has been brought in to incentivise local authorities to build by matching council tax on new properties for six years, payable for homes completed in the previous year. However, as an untargeted scheme, it might not channel resources to the areas where there is greatest need or demand, prompting one former housing minister, John Healey, to observe that 'we could quite literally see government robbing Peterborough to pay Poole' (BBC News 2010). Nor will the unhypothecated monies received by local authorities through the NHB necessarily be reinvested in increasing housing supply. The scheme offers only a very limited incentive to local authorities, local residents and planning committees to support the provision of new housing (Larkin et al 2011). Indeed, there is already evidence to suggest that the removal of regional targets for house-building has led some planning authorities to reduce their completion targets, despite the inception of the NHB: 'councils, particularly in the south, say they will build less, not more' (Leunig 2011) and 'it has been argued by the South East Strategic Leaders (of local authorities) that NHB payments will be insufficient inducement for councils to change their attitudes towards new development' (Pawson and Wilcox 2011).

Second, the new Affordable Rent scheme is intended to encourage registered social landlords to build more homes by enabling them to increase the rents they charge on new tenancies to up to 80 per cent of the market rate.[3] In parts of the country where houses are of lower value and 80 per cent of market rent is no higher than existing social rents, it will not provide additional revenue against which to borrow in order to build. In areas like the east of England, where there is a significant difference between market rents and social rents, but where 80 per cent of market rent would still fall below the new benefit caps, the scheme may work in providing funding for the construction of new homes (albeit by increasing housing benefit expenditure). In areas of London, where social rents are often lower than 30 per cent of market rent, benefit caps could make the new 'Affordable Rent' unaffordable. Table 1.1 provides a sense of how much more this might mean by

3 As an aside, 'Affordable Rent' presents particular problems for re-lets, as it involves telling tenants that, although they live in identical, neighbouring properties owned by the same landlord, they should pay different rents, and the one that pays more gets less, as they will also have shorter (flexible) tenure. Tying higher rents to a deterioration in tenancy terms suggests a problematic policy collision.

way of rent charged from families in social housing, if housing associations were to opt to charge the full 80 per cent of market rent on new tenancies.

Table 1.1
Average social, affordable and market rents for a three-bedroom property (£/week)

	England	London
Social rent	84.56	110.00
Affordable rent	249.00	350.00
Market rent	311.25	437.50

Source: Seabeck 2010

The impact on house-building of the introduction of Affordable Rent will depend, in the short-to-medium term, upon how many homes in the existing pipeline are to be let at this new rate, and how many re-lets will change to it. There is a risk that housing associations, many of which have stock distributed around the country, will charge Affordable Rents in places where demand is greatest but then use the additional revenue to build homes where it is cheapest to do so, where demand is less. And risk-averse financial institutions, such as Santander, are proving wary of recognising Affordable Rent in their valuation calculations, insisting instead on using the existing Use Value of Social Housing, based on current social rents. Notwithstanding these concerns, housing minister Grant Shapps recently announced that, as a result of the scheme, 146 providers will share £1.8 billion to develop 80,000 new homes, 'putting us on track to deliver up to 170,000 new affordable homes across the country over the next four years' (DCLG 2011b). A key question then is what happens thereafter. Housing associations' assets can only realistically be squeezed in this way once. The government has no definite plans for Affordable Rent beyond 2015, but housing associations insist that they will have reached their gearing limits by then. The communities minister, Andrew Stunell, has acknowledged that there are difficult questions about the scheme's viability beyond this point, recognising that housing associations' assets 'are not inexhaustible' (Wellman 2011). Affordable Rent is a major plank of the government's approach to funding new house-building, but it is unlikely to last in its current form beyond 2015.

Third, current reforms to the HRA should allow greater flexibility to local authorities who want to see more house-building in their areas. These reforms, essentially localising the choice as to how to service housing debt, and how quickly, under a new self-financing regime, should lead to the supply of new homes. This ought to be particularly true in areas that have already achieved 'Decent Homes' standard but will depend upon the amount of borrowing 'headroom' available to each local authority.

Finally, the government believes that, having abolished regional house-building targets and spatial strategies, the changes to the planning system it is proposing in its new National Planning Policy Framework, such as a presumption in favour of sustainable development, will lead to higher levels of house-building. The government's reforms to the planning system are radical – top-down targets are being replaced with bottom-up incentives – and their implications for levels of future house-building are unknown. It is to be hoped that increased localism in planning (for example, through local ballots or referendums) will give voice to the voiceless – those in housing need – rather than amplifying the voice of those who already shout loudest, namely homeowners using the planning system to protect their house prices by blocking new development. Given that half of all people in the UK, when surveyed, support the building of more homes in their community, compared with a quarter who do not (Ipsos MORI 2011), the planning system needs to give more people a

vote, not a veto. There is a danger though that removing the regional layer of government effectively removes someone 'above' for local councillors to 'blame' for new house-building, which may actually make securing planning permission for new homes harder. It also makes it harder to work across local authority boundaries, which are not necessarily coterminous with local housing markets.

The prime minister has said that 'we do need to build more houses',[4] but government policy as it is currently configured does not appear to be up to the scale of the challenge the country faces in terms of building new homes. Meanwhile, homelessness is on the rise for the first time since 2003 (Fitzpatrick et al 2011).

4 Prime Minister's Questions, 14 September 2011

2. A BRIEF ACCOUNT OF SOME COMMON PROPOSALS

The fundamental question that we, as a country, must answer is: 'How can we pay for building new homes?' Here we briefly describe some of the more frequently suggested answers to that question.

Increase central government investment in new homes

History tells us that the only really significant surges in housing supply have come with increased government spending. Homes are a critical part of our national infrastructure and, as such, merit substantial government investment. We should think of it in these terms – stimulation of the economy through investment in a solid asset – rather than as subsidy. Council property, for example, pays for itself within 30 years of being built. The previous government invested heavily in bringing existing properties up to scratch through the Decent Homes programme, but it did not, in the end, do enough to fund new supply. In the next and future spending reviews, government should increase the share of public spending that goes on building much-needed homes. Any aversion government may feel to the idea of offering people lifelong security of tenure at low rents, regardless of their changing circumstances, ought to be treated separately from the idea of government investing in building new homes: the two are distinct and need not go hand-in-hand. But aspirations for increasing capital spend on new housing in the next decade seem unlikely to be fulfilled. It is probable instead that government (as in the latest spending review) will choose to spend the limited capital it has available on investment that it believes supports growth more directly.

Allow local authorities to build homes with off-balance-sheet borrowing

One way to increase state investment in new homes would be to allow local authorities to build more by taking their borrowing for the purpose of house-building out of the public sector borrowing requirement (PSBR), so that it does not count towards the national deficit. By allowing (as we currently do) housing associations (in the private not-for-profit corporate sector) to build outside of the PSBR, but not local authorities (which are classified in the public corporate sector), as a nation we effectively pay a higher interest rate premium to borrow to build at no lower risk. Reclassifying borrowing for house-building to take it off the PSBR, while not without risk, would bring it into alignment with, for example, foundation hospitals in the NHS. Indeed, there may be a stronger case for housing investment, which is supported by future rental streams, than foundation hospitals, which are supported by taxpayer revenue. This would mean adopting accounting practice that is widespread elsewhere in Europe.

It is possible that the difference in designation for national accounts purposes between housing associations and local authorities will be reviewed by the UK Statistics Authority anyway, since, according to certain criteria (for example, government's ability to hire and fire the members of their boards) housing associations could be considered part of the public sector. Indeed, the Court of Appeal's judgment in the Weaver case – that housing associations are public bodies – would seem to support this view.[5] This could bring their multi-billion pound borrowing in scope as public sector net debt. But that would not matter if the UK, like many of its European neighbours, adopted fiscal rules based on general government rather than public sector debt (Wilcox 2009).

Reform housing associations

Housing associations in all their diversity own or manage nearly 2.4 million homes, or 10 per cent of the national housing stock, have land banks worth in excess of £1.3 billion

5 See http://www.charlesrussell.co.uk/UserFiles/file/pdf/Real%20Estate/Article_-_The_Weaver_case_-_July_2009.pdf

and assets valued at £94.6 billion (Elphicke 2010). They are now at a crossroads. They have emerged from the credit crunch reasonably healthy and are still able to access finance on relatively favourable terms. But HM Treasury is poring over their books, asking how as much value as possible can be squeezed from their assets. Indeed, the introduction by the government of the Affordable Rent regime is intended, in part, to sweat those assets. But many housing associations report that, after four or five years under this new regime, their gearing will reach its limits. Large housing associations are beginning to go to the bond market for funds. Places for People, for example, recently raised £175 million at a five per cent fixed yield in the social housing sector's first unsecured issue on the UK bond market (Brown 2011).

Reform will be needed, as reliance on government grant is decreasingly viable. But it will require significant culture change among the boards and staff of housing associations, as they move into a riskier, more competitive, demand-led, quasi-private operating environment.

This process of change will involve identifying ways to make the most of the £45 billion of government grant locked up as equity in housing associations (Orbit 2011). They will need to get better at asset and portfolio management. And developing and non-developing associations will need to work together. Further syndication will enable them to secure finance. Collaboration, for instance through shared services, will enhance their efficiency. In some cases, mergers will deliver economies of scale. In short, the sector as its stands is disjointed, fragmented and inefficient, and this has to change.

Continue private sector cross-subsidy of affordable homes

In recent years, the application of affordable housing targets to privately developed sites through planning policy and section 106 (s106) requirements has enabled local authorities to increase the supply of affordable housing with limited recourse to public funds. Half of all s106 money has been housing-generated. That said, less than one per cent of new social rented homes and just over two per cent of new low-cost homeownership homes built in 2009/10 were funded solely by s106 agreements without government grant. In the north west, for example, no social or low-cost homeownership properties at all were funded in this way that year (DCLG, live table 1000). With stagnating house prices, the cross-subsidy model is now significantly less attractive to speculative developers. Nonetheless, in London and the south east where land values remain high, this model, especially if supported by some form of local housing bond, can still be viable.

Release land owned by central government

Government is well placed to support the provision of affordable housing through land disposal at discounted prices which allows added value to be held as equity for public benefit. Such an approach, with the state taking an equity stake in the appreciation of market and shared ownership homes, secures long-term public benefit while reducing the cost of building new affordable homes. Between a quarter and a third of all land with the potential for residential development is owned by the public sector (HBF 2011). However, of that, only two per cent is owned by central government, while over half (51 per cent) is owned by local authorities (OFT 2008).

Nonetheless, given the current overhang in land prices, giving away some of that public land currently owned by central government departments for the purposes of development will certainly assist if we are to reach the levels of house-building we need. The majority of all new housing since 2009 has involved subsidy: if, in future, this subsidy

is not available in terms of grant, it will need to be made available in terms of land. But we must not be naive about the potential of this solution: it is a straw that previous governments have also clutched at, only to discover that departments are reticent to dispose of their assets, or need an immediate receipt as opposed to a deferred one, and much of the land in question has not been developed before for a reason – that it is not of the right quality or in the right places for new homes. As the oft-heralded solution to our problems of housing supply, it has not lived up to the hype.

Upscale community-led models

Many commentators view community-led models of house-building as worthy but essentially peripheral. But the (increasing) proportion of new homes that are self-build – around 12 per cent, or up to 20,000 homes each year (NaSBA 2011) – may suggest that community-led models could have the potential to offer a mainstream, volume solution, delivering more affordable, greener, and higher-quality homes. In some other European countries, self-build accounts for over half of all new homes (NaSBA 2008). In its recent report, An action plan to promote the growth of self build housing in the UK, the National Self Build Association (NaSBA 2011) calls for more land to be made available for self-builders, for lenders to offer them tailored financial products, and for revolving funds to be established to support group self-build schemes – recommendations to which a government committed to localism may prove receptive. Moreover, the new national planning framework, featuring a 'presumption in favour of sustainable development' and a 'community right to build', should make it easier for individuals and communities to opt to build their own homes.

Community land trusts are used around the world as a mutual way to deliver low-cost homeownership for families and local communities in perpetuity. Well established in rural areas of the UK, particularly parts of Scotland and south west England, they have yet to catch on in urban settings. London Citizens is engaged in a proof-of-concept exercise with a community land trust they have fostered at the 1.85 hectare site of St Clement's Hospital on the Bow Road in east London. This East London Community Land Trust is currently bidding for the HCA's tender to develop the site. Should it prove successful, others may follow, both in London and elsewhere. It seems likely that collective forms of community building such as this may be more successful at attracting the involvement of less-affluent people than individual self-build, which has a reputation for being a pursuit reserved for the privileged. The difficulties of upscaling such activity to produce supply at volume, however, should not be underestimated: it is a time-consuming approach to delivering new homes that relies heavily upon land being available at far below market price, if not for free.

As well as communities acquiring land and building their own homes, community management of property may also offer a way to unlock much-needed finance. Tenant management organisations, and, even more so, tenant management cooperatives tend to be more efficient than local authorities at managing housing stock, as demonstrated by their significant operating surpluses (they get the same money from the local authority for management services as the local authority would spend itself, and then they spend it more efficiently, meaning they generate a surplus). If tenants, properly constituted, can look after estates better than local authorities, without any profit motive, and do so more efficiently, then tenant-managed property might be able to offer a better rate of return to potential investors. It may be worth reflecting on whether such a coming together of high finance and grassroots communitarianism has the potential to get new homes built.

Reform tax

Government could generate money to invest in building new homes by adopting a more progressive approach to taxing real estate. Homeownership is currently highly privileged for tax purposes. In particular, there may be scope for greater taxation of unearned wealth and a crackdown on tax avoidance. Indeed, the current period of stabilisation in house prices may present a political window of opportunity for such a move. Certainly, a more assertive approach to taxing rich foreign investors in UK residential property would encounter little domestic political resistance. There are property fairs every week in Hong Kong and Singapore where (mainly London) homes are sold to the wealthy overseas. Now, 60 per cent of London properties worth over £2.5 million are owned by foreign investors (Adams 2011). We could do more to capture some of the value of these properties by doing away with the special exemption from capital gains tax and stamp duty that non-UK residents currently enjoy (Gibson 2011). The income generated could then be channelled into building new homes. Stamp duty could move from a 'slab' system that bunches transactions to a marginal rate 'slice' structure, similar to income tax, likely both to be fairer and to generate greater tax revenues that could be channelled into new house-building (JRF 2011). As part of a wider – ideally cross-party – review of local government finance, council tax bands could be expanded in number and regularly revalued and uprated with house prices and council tax benefit could be replaced by a council tax rebate, drawing on the data to be collated for administration of the universal credit, in order to increase uptake (JRF 2011).

3. THREE PROMISING PROSPECTS

Having described most of the more frequently suggested options, we now develop three such ideas that we at IPPR think hold particular promise in terms of finding finance for new homes.

3.1 Institutional investment in building new homes

Summary of suggestions

- Focus on domestic insurance and pension funds
- Do detailed work to develop attractive products that address potential investors' actual concerns
- Actively promote the idea not just to investors but also to their consultants, actuaries and asset managers
- Local authorities' pension funds may offer the best prospect

Greater institutional investment – which does make up a small element of the finance of housing supply in other European countries, and did in the UK in the early-mid 20th century – has long been seen as one possible element of a solution to the UK's problem of insufficient housing supply, particularly in the private rented sector (PRS), and especially in London. Only last year, HM Treasury consulted widely on how to increase institutional investment in the PRS (HM Treasury 2010). And yet, according to Charles Fairhurst (Chair of the Residential Property Group of the Investment Property Forum), of the 65 biggest global investors, only 13 do not invest in residential property, and 11 of these are in the UK. Now, only one per cent of UK insurance and pension funds' overall investment in property is in the residential sector (Alakeson 2011).

An important question then is whether the conditions here now, post-crash, with stagnant house prices potentially forcing the PRS into an income rather than a capital model, are more conducive than they were before to institutional investment, particularly if residential property could be packaged and offered at scale in an off-the-shelf, professionally managed, hassle-free way.

Before proceeding to an analysis of the prospects for institutional investment in UK residential property, one note of caution should be sounded. Lessons from the investment-driven commercial property boom in the UK in the first half of the last decade teach us that fast flows of finance into a property market without adequate absorptive capacity can simply drive up prices rather than increase supply (Capital Economics 2007). Additional residential investment, particularly if geographically concentrated, or if it is directed into existing stock, might have the same effect, increasing prices, not supply. Institutional investment in residential property needs to be geared towards building new homes.

It has been estimated that investment funds bought just 4.5 per cent of new homes sold in London in 2006 (Craine and Mason 2006). Since the London market is seen as the most attractive (because of its size), investment in the rest of the country is likely to have been lower, and HM Treasury noted that there had been 'recent disinvestment by institutions' (HM Treasury 2010). In the immediate post-war period, major insurance companies, such as Prudential and Sun Alliance, had large holdings of residential property but these were reduced following the introduction of short-hold tenancy law and rent control (Grant and Sankoli 2007). The hope is that a return of institutional investors to the market would lead to more – and better quality – homes.

Life assurance companies like Prudential are still important potential institutional investors in residential property today, alongside pension funds. Other institutional investors, including hedge funds, private equity funds and sovereign wealth funds, are less likely to invest. Commercial property funds have been mentioned as potential investors in residential property – although ultimately they could only do so if the investors in their funds were willing. Overseas pension and insurance funds, particularly those that have experience of investing in the sector in their own country, might be attracted to invest in UK residential property while sterling's exchange rate is weak, although participants at a Treasury roundtable believed they will need to see more evidence of investment in homes before entering the market themselves (HM Treasury 2010). So, if there is to be substantial institutional investment, most of the money will have to come from domestic insurance and defined benefit pension funds,[6] so the rest of this section focuses on the likelihood of them investing in UK residential property.

Investment strategy

Generally speaking, insurance and pension funds set their long-term investment strategy using the capital asset pricing model (CAPM). At its core, CAPM assumes that riskier assets (those where returns are most volatile) will have higher total returns[7] than less risky assets. Therefore, cash – the least risky asset – will have the lowest return; government bonds (gilts) will have a higher return; and equities – the most risky asset – will have the highest return. Broadly speaking, over very long periods, this turns out to be true. CAPM then asserts that investors will choose a portfolio of assets – a mix of cash, gilts and equities – that reflects their risk profile. A risk-loving investor will have a high weighting in equities; a risk-averse investor more cash and bonds. In the long-run, the risk-loving investor will be rewarded for taking on more risk by higher returns.

Commercial property can be slotted easily into this framework. It tends to have a higher return and to be more risky than gilts, but a lower return and to be less volatile than equities. However, in the CAPM, as more potential assets are added to the model, another factor becomes important: the correlation of the returns delivered by the different asset classes. In order to minimise the volatility of overall portfolio returns, it is better (other things being equal) to combine assets whose returns are negatively correlated, rather than those with returns that are positively correlated. To understand this, consider a simple example. Suppose I already own a portfolio consisting entirely of equities and I want to reduce the volatility of that portfolio by adding another asset. Suppose further that there are two other assets that I can choose from that offer the same return and have the same volatility as each other. But suppose the value of one always goes up when the equity market is rising (and down when the equity market is falling); but that the value of the other always goes down when the equity market is rising and vice versa. Clearly, if my main concern is to reduce the overall volatility of my portfolio, then I will do better to add the second asset.

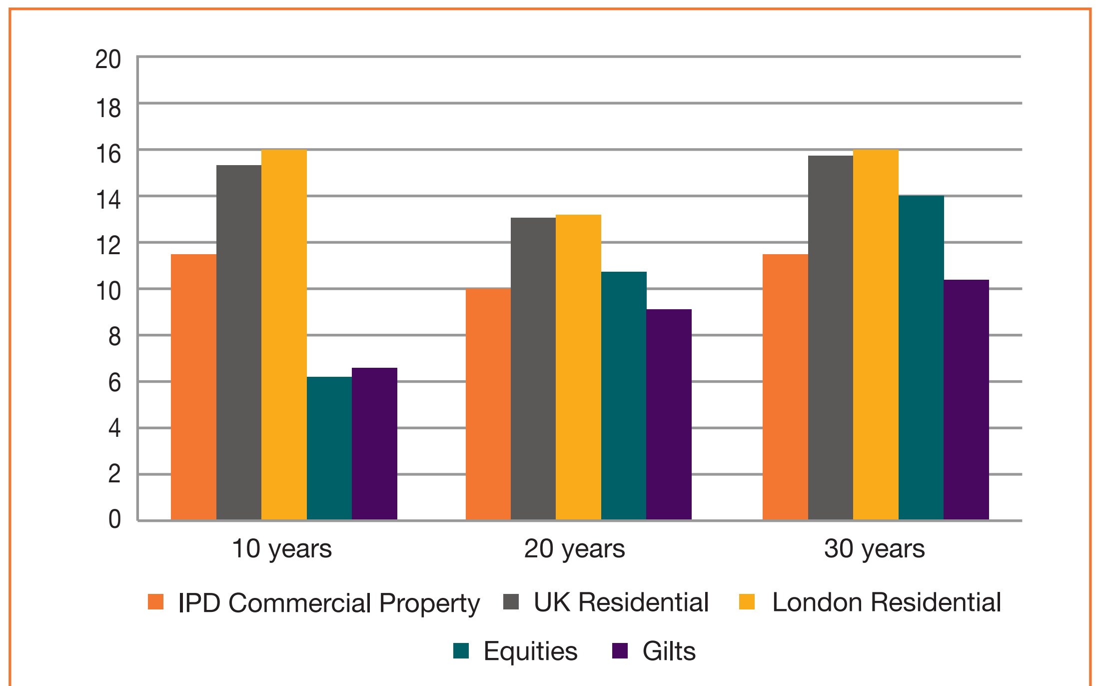
Where does residential property fit into this framework? Based on historical returns, volatility and correlations, it would be an excellent asset to add to a portfolio comprising cash, gilts and equities (that is, the type of portfolio typically held by UK insurance and

6 Although in theory funds could also be set up to encourage investors in defined contribution pension schemes to invest in residential property, most financial advisers would argue that, as these investors will for the most part be homeowners, their exposure to the housing market is already large enough and that their pension savings should be placed in other assets.

7 Total return = income (for example, from dividends, rents or interest payments) plus any capital appreciation less any costs associated with buying, holding and selling the asset.

pension funds). Residential property has had a higher total return over long (20 or 30 year) periods than any of these asset classes, its returns have been less volatile than equity returns and they have been negatively correlated with gilt and equity returns (Daly 2008).

Figure 3.1
Annualised total returns of asset classes (total returns compound per annum)



Source: Reproduced from Savills Research, IPD, in Daly 2008

However, there are some statistical and other problems with this conclusion. The value of equities and gilts can be measured in financial markets on a minute-by-minute basis and trading volumes are enormous, relative to the activities of any one investor. Therefore, it is reasonable to say that, if the equity market went up by 10 per cent last year, this is the return I would have received, less investment fees, if I had invested on 1 January and sold on 31 December (assuming investment in an index-matching fund). Similarly, the volatility of my portfolio would have matched the volatility of the market. The same is not true for investing in residential (or for that matter commercial) property. Indices of house prices – such as those produced monthly by the Halifax and Nationwide – are an imprecise measure of the value of the overall housing stock. More importantly, because there is no equivalent of the equity index fund, they will not reflect changes in the value of any particular portfolio of residential property. Nor do they capture the discount that might need to be offered to 'market value' to sell a particular property. And, for the same reason – and because they are only monthly measures – they will tend to underestimate the relative volatility of residential property.

Even ignoring these problems, the CAPM only takes us so far in understanding how institutional investors construct their portfolios. Two additional factors are also important: matching their liabilities, and liquidity.

For insurance companies and pension funds, the most important risk is not the volatility of their returns; it is the possibility that, at some point in the future, they will not be able to make the payments that they have contracted to (that is, they will not be able to meet

their liabilities). In the case of an insurance company, this would put it out of business; in the case of a pension fund it would mean beneficiaries not receiving the pension payments they expected. This means they are biased towards assets whose returns in the future are most likely to match the growth of their liabilities. As liabilities tend to rise in line with average earnings or inflation, this means assets that are a good inflation hedge. Residential property scores well on this count – unsurprisingly, there is a strong correlation between rental incomes, house prices and general inflation in the economy.

However, as defined-benefit pension schemes have been closed, particularly in the private sector, companies have moved to match their pension liabilities ever more closely to their assets, so as to minimise the effect of unpredictable swings in financial markets on their balance sheets. This means shifting greater proportions of their assets into gilts and index-linked gilts, which are the best inflation hedge of all. In such circumstances, a move into residential property is unlikely.[8]

Residential property scores poorly on the other count: liquidity. Institutional investors like to know that they will be able to sell their assets at short notice at the current market value. Excepting episodes like the 1987 stock market crash, this is true of equities and gilts. It is not so true of property. Equities and gilts can be sold 'into the market'; sellers of property have to find a buyer. At times of market weakness, this might not be possible – or only be possible by accepting a large discount on the current market value (as investors in commercial property found out in 2008 and 2009). It is also the case that there is no derivative market that institutions could use to increase or reduce their exposure to residential property in the short term, pending purchases or sales of physical stock. Furthermore, institutions know that equity and bond prices will be determined largely in a market in which they are the dominant players. By contrast, prices in the residential property market are determined mainly by owner occupiers.

The theoretical CAPM case for investment in residential property is not, therefore, as strong as it first appears.

Obstacles to institutional investment

A number of studies have looked at why institutional investors are not significant players in the residential property market (see for example Daly 2008, Bill et al 2008 and Crook and Kemp 2010) and the same factors tend to come out in all of them. Institutional investors do not believe there is value in residential property and they do not want the perceived hassle of dealing with it.

In the earlier discussion of the simple CAPM model, we said that it made residential property look attractive based on historical returns, volatility and the correlation of returns with other assets. However, these are all water under the bridge. Investors today are concerned not with historical returns but with expected future returns and, as all the investment promotional material says, past returns are not necessarily a guide to the future. The rental yield on residential property is significantly lower than on commercial property – 3.5 per cent net, compared to 7.3 per cent in March 2010 (HM Treasury 2010) – and there is no guarantee that future increases in house prices will outstrip increases in commercial property prices. Indeed, the low yield on residential property may indicate that it is overvalued and will increase less rapidly in price. Alternatively, the low yield may be sustainable if homeowners, who largely determine house prices, value property more

8 Such close matching of assets and liabilities is less of an issue for public sector pension schemes, so these might offer more hope for investment in residential property.

highly than institutional investors (because they use criteria other than comparisons with the value of other assets). But this does not make it attractive to institutional investors – indeed it creates a permanent barrier.

Other factors that can reduce potential returns are the costs of buying and selling property and the cost of managing it. Short leases mean there is uncertainty about the projected stream of rental income and increase the risk that property will be void for extended periods of time.

The hassle of owning residential property comes in a number of forms. Owning residential property is seen as increasing reputational risk – particularly as politicians (both national and local) are felt more likely to side with tenants than landlords (among whom there are fewer votes) in any dispute. Managing residential property is expensive and time-consuming. In the commercial world, tenants are responsible for maintaining the condition of property; in the residential world, the burden falls on the owner and VAT on spending on repairs and maintenance is not reclaimable, even for a tax-exempt investor such as a pension fund. This also means there is less incentive for tenants to look after residential property.

In theory, owning a large number of properties should lead to economies of scale in management costs, but in practice these have failed to materialise (Crook and Kemp 2010). In part, this is because portfolios of properties tend to be difficult to assemble (except with new-build) and so tend to be fragmented, which is good for diversification of risk, reducing exposure to a particular property type or location. The alternative route to obtaining diversification – investing through a fund of funds structure – is more costly because of the added layers of fees.

Economies of scale might be increased if institutional investors could be persuaded to invest in new properties (build-to-let) and to hold onto these properties for a number of years – but diversification would be difficult in such circumstances. Some of these problems might also be diminished if investors were able to work with local authorities and registered social landlords (RSLs) to build and let social housing. Extensive waiting lists for social housing mean that voids will almost always be lower; tenant turnover is also lower in social housing; management costs can be shared; and income is, to a certain extent, underwritten by the government.

Thought has also been given to different ways in which institutional investors could acquire equity in residential investment. Williams et al detail several methods, including investing in newly created registered providers or existing housing associations, setting up a social housing trust, investing in private registered providers or directly into housing assets and investing in shared ownership schemes (Williams et al 2011). As yet, though, these represent interesting ideas, rather than schemes that insurance companies and pension funds are actually using.

Allowing real estate investment trusts (REITs) to invest in residential property – one of the last government's responses to the Barker review of housing supply in the UK – has been seen as a possible way of getting around some of the problems facing institutional investors. In theory, REITs increase liquidity for individual investors (although not, in practice, if they all want to sell at the same time – and the 'herd instinct' of institutional investors should never be underestimated). They also increase diversification, so spreading risk, and are more tax efficient than buying residential property directly (being exempt from corporation tax, income tax on rental yields and capital gains tax on reinvested capital gains). It should be noted from international experience, however, that

REITs (or their equivalents) appear to work much better for investment in existing stock than investment in new-build. So far, anyway, they have failed to take off here.

One problem is that conversion to a REIT attracts a two per cent upfront charge. Abolishing this charge is one of a package of measures proposed at the time of the March 2011 budget to make residential property more attractive to institutional investors and on which HM Revenue and Customs has been consulting. The other main measures are to allow REITs to list on the Alternative Investment Market (AIM) and a change to the way stamp duty on bulk purchases is accounted. At present, when purchasing a portfolio of properties, liability for stamp duty is assessed on the value of the total portfolio (and so is paid at the top rate of five per cent on any portfolio valued at over £1 million). The change proposes looking through to the value of the individual properties, so on a portfolio of six properties all valued at £300,000, stamp duty of just three per cent would be paid. While these changes have generally been welcomed, they are seen as marginal to the decision to invest in residential property by large institutional investors. For example, participants at the Treasury's 2010 roundtable said the changes now being proposed to the way stamp duty is calculated are necessary but insufficient to make a significant difference to the level of institutional investment (HM Treasury 2010). Further systematic tax breaks, however, appear unlikely.

It might seem, therefore, that the UK is unlikely to see substantial investment by institutional investors in the residential housing market. Although the government is taking some steps in the right direction, the main problems are valuation and the structure of the housing market, and there is little that can be done about those.

Reasons for optimism

There are, however, some positive signs.

Terra Firma Capital Partners (a private equity firm) has invested in Annington Homes, a company that buys homes from the Ministry of Defence, refurbishes them, and then sells them into the national housing stock. In September 2010, the Homes and Communities Agency (HCA) announced that it had established the first private rental fund with the Berkeley Group (HCA 2010). Over the next two years, more than 555 homes built in Kent and Medway by the Berkeley Group will be purchased by the fund and retained for rent on the open market. Over two years, 555 homes is small beer compared with the 250,000 new homes that the UK needs to build annually, but if the scheme's investors report positively on the experience, this could represent the start of new wave of institutional investment in residential property in the UK. It has also been reported that the changes to stamp duty mentioned above will lead to increased interest from Asian pension funds – although at this stage this seems to be mainly speculation on the part of market analysts (Shadbolt 2011).

The Resolution Foundation has been working with Allsop property consultants to develop a model for a fund to invest in a broad, national mix of residential developments, exploiting the benefits of diversification. They are setting a target internal rate of return of 12 per cent over a 30-year period (Alakeson 2011).

In London, where institutional investment in residential property seems most likely, discussions have taken place for some time between the Greater London Authority and potential investors. But those investors say they want a guaranteed or underwritten net yield of eight per cent, which is high and hard to deliver. They also want volume

very quickly, for example, 2,000 units within two years. Work continues to test such an approach on specific parcels of land to see if a formula can be found that might work.

The apparent interest in investing in residential property of a handful of public sector pension funds, such as the (£3.5 billion+) London Pensions Fund Authority (IPE 2010), offers probably the best hope of attracting institutional funds into the sector. However, institutional pension funds – or rather their trustees – are, for the most part, very conservative and reluctant to adopt new investment ideas. A concerted effort would be needed to sell the idea of investment in residential property to them. This would have to be done directly, but also through the investment consultants and actuaries that they employ for investment advice and through their asset managers too.

Local authorities' pension funds

Perhaps the best prospect for institutional investment in residential property is local authorities' pension funds. These funds are sizeable, and the councillors who sit on their management boards understand the need for more housing better than most, as they hear first-hand experience of it from their constituents in their regular surgeries. And while these funds need to be safe (in terms of securing a reasonable yield for their pension-holders), they can also be patient.

There are some emerging precedents for local authorities investing their pension funds in residential property.

In the London Borough of Newham discussions are under way with the Mill Group about the prospect of using the local authority's pension fund to invest in the Investors in Housing fund, co-investing with people looking to buy their first home, enabling them to move from the rented sector, or from living at home with their parents, sooner than they would otherwise have been able to do. This would involve the purchase of good quality existing (as opposed to new-build) properties in Newham and elsewhere. The model under discussion is one whereby the London Borough of Newham would put in 50 per cent as an equity stake, another investor – as yet unidentified – would put in a further 45 per cent stake, and the prospective resident would put in the remaining five per cent to part-buy the property. The scheme would be aimed primarily at young professionals who can afford the monthly payments associated with home-buying but who do not currently have the savings to arrange the deposit for a mortgage. After six or seven years they would be expected to buy the properties in full, providing an exit strategy for the fund. The Mill Group describes the model as highly predictable, low-volatility and low-risk, with a target internal rate of return of 10.5 per cent or more and a forecast average annual cash return of six per cent or more, achieved in part by transferring the costs of maintenance to occupiers with strong credit ratings.

The Greater Manchester Pension Fund, administered by Tameside Council, brings together the pension funds of all ten local authorities in Greater Manchester plus those of over 200 other employers in the area. It is therefore able to invest across a wide area, reducing concerns about individual local authorities investing in their own back yard. The fund, which already invests in commercial property, is now actively exploring the potential for investment in residential property to build new houses for sale or rent. The fund has twin aims: achieving a commercial return, and supporting the local area. It cannot simply be a source of 'soft capital', but it can legitimately look to invest in the local area, provided it meets its primary aim of commercial return: its two interests need not conflict. Recently, its board raised the maximum limit for the proportion of its funds that could be invested

locally from three per cent to five per cent (equivalent to approximately £500 million), enabling it to invest at scale. The fund's managers are currently looking to put together possible packages – involving the fund, a local authority, a contractor and a landlord – to reach their target rate of return.

Earlier this year, it was reported that the Scottish government is in discussion with Strathclyde Pension Fund and Calmac Pension Fund about investment with local authorities in affordable housing, with housing minister Alex Neil saying, 'I'm encouraged by the willingness of pension funds like Strathclyde, Calmac, and other institutions to discuss possible future investment in social and affordable housing' (Twinch 2011). Indeed, through the National Housing Trust initiative, the Scottish government has been pursuing possible new models of finance for house-building since the credit crunch, as well as accelerating existing investment programmes. The approach, de-risked by government underwriting, looks to bring Scottish local authorities on board to invest in affordable rented housing. Initially, the scheme bought up unsold stock on developers' books, but now it is helping to kickstart schemes that had stalled because of banks decreasing willingness to lend. The model is based on future sales of the property after a period of five or more years of rental, thereby enabling developers to keep construction going but defer sales for five years, when they hope the market will look better. The house has to be sold at market value, but it can be purchased by the tenant or a local authority or RSL. As for institutional investment by local authorities' pension funds, design work is ongoing to make this possible by achieving a seven per cent return with a ready-made delivery vehicle, reaching scale by aggregating procurement nationally.

These precedents across the UK suggest that the prospect of securing finance for building new homes from the pension funds of local authorities definitely merits further exploration.

3.2 The role of local authorities

Summary of suggestions

- Local authorities should make their land available to developers, free or at a discounted rate, in return for an equity stake in the development
- Local authorities should adopt a more assertive 'use it or lose it' approach to privately held land in their areas, including time-limited planning permissions and compulsory purchase orders
- Land auction pilots should commence
- Local authorities should exploit the house-building opportunities afforded by HRA reform

Local authorities' public land

Just as central government can release the land it owns to enable development, so can local authorities. And local authorities own much more of it.

In the London Borough of Islington, for example, where the local authority has rejected the government's Affordable Rent scheme as unaffordable, the council is funding the building of new affordable homes by making land available to housing associations at a discounted rate for this purpose. The council has enough land to give away like this for one spending round only, but it deems that to be the likely lifecycle of Affordable Rent anyway.

Under the old regime, a typical housing association development in Islington would be financed 40 per cent by government grant (HCA), 10 per cent by cross-subsidy, and 50 per cent by borrowing against rents. Under the new Affordable Rent regime, the government expects similar developments to be financed, for the sake of argument, 15 per cent by grant, 10 per cent by cross-subsidy, and 75 per cent by borrowing against (higher) rents. Islington council is saying it would like housing associations to retain social rents and so it will help plug the funding gap by offering land at discounted value or free, as subsidy in kind, plus some capital, for example, from the NHB. In London, the south east and east of England, where residential land value is still £2 million or more per hectare (VOA 2009), such an approach is viable.

Barking and Dagenham council has secured institutional funds to finance the construction of 500 new homes, which it will manage, to house people on low incomes, charging them below market rents (thereby removing any s106 requirements on the developer). To secure this deal, the council has given two plots of its land over for the development and is offering the investor a guaranteed rental stream for 60 years, after which the council will assume ownership of the homes. As London Councils, the British Property Federation and Allsop have observed:

> **'No private rented scheme will be attractive to institutional investors without it being able to deliver appropriate financial returns over the medium to long-term. Through contributions of land or investment, local authorities may be able to ensure the success of such schemes. However, just like investors, boroughs will be looking for financial returns on their investment and tangible benefits for local people and communities.'**
> Allsop 2011

Extending the ability then of local authorities to secure equity stakes in major private developments, repayable against future sale, rather than other forms of planning gain, guarantees a return for public housing from private market appreciation. And releasing land on deferred terms that do not require upfront payment helps get around current constraints on development finance.

Local authorities and private land

Reducing the price of private land, and therefore houses, is also essential if we want to build more homes. The price of land has risen more quickly than the price of any other commodity in recent years. Land accounts for a large proportion, ranging from a quarter to three-quarters, of the cost of building a house. Rising land prices were, therefore, a primary driver of the steep rise in house prices (which trebled within a decade) as the last housing bubble inflated, putting home-ownership beyond the reach of many and prompting others to borrow beyond their means.

Those who own farmland (or, say, industrial land as an equivalent in cities) can commonly sell it for development at over 30 times its value for agricultural use – rising to up to 700 times with planning permission in some places (Foresight 2010). This may make a lot of money for farmers, but it is keeping house prices for everyone else artificially high, and it is damaging the economy in the process. The problem is that the current system of 'development plans effectively gives away to landowners the value created by the local community from the planning system' (Leunig 2007). A promising response to this

situation is the idea of land auctions, as advocated by Professor Tim Leunig of Centre Forum and the London School of Economics (Leunig 2007).

According to this proposal, every four years (to alternate with local elections) a local authority would run a development round. In that development round, anyone who owns land in the area could indicate their willingness to sell it, and name their price. The local authority (only) can then purchase the right to buy pieces of land it deems suitable for development at the prices named. It would look not to pay more than, say, five times agricultural value for it. The local authority would then hold an auction to sell off the land it had purchased, with outline planning permission, to developers, who would pay more in the auction than the price for which it had been purchased by the local authority in the development round. The local authority would then get to keep the difference – likely to amount to around £3 million/hectare, or £85,000/house (Leunig 2007) – to spend on whatever it liked, including improved services for local people.

In essence, land auctions are a land value capture mechanism, offering a form of rolled-up, upfront, local land value tax that specifically targets undeveloped land. The expected results would be that:

- land prices go down, due to an increase in supply
- landowners make a profit, albeit less than they might make today
- local authorities (and the communities they serve) are strongly financially incentivised to make land available with planning permission to developers, turning 'NIMBY' councils into 'IMBY' councils
- barriers to entry into the market for small developers are removed (Kate Barker identified planning as the key barrier to new market entrants and recognised the utility of auctions)
- developers no longer land-bank, as they can now expect land prices to fall rather than rise
- more homes get built where they are needed
- house prices go down, due to an increase in supply and cheaper land
- the system is self-regulating, unlike the New Homes Bonus, and delivers much more than it, by a factor of ten, by way of incentive for local authorities.

Implementation of the idea of land auctions, aligning state and market incentives, may not require new primary legislation. Because the Localism Bill currently going through parliament states that financial considerations can be material for planning committees, secondary legislation may suffice to create a permissive system – that is, one that is optional for local authorities to adopt, in the expectation that, over time, they would adopt it. Pilot land auctions were announced in the chancellor's 2011 budget. Government should now confirm the locations and timing of these pilots.

Land-banking by developers is also a real problem, especially when holding land with planning consent can be as lucrative as actually building and selling homes. The message from local authorities to developers in their areas who are banking developable land should be 'use it or lose it'. This should mean increased use of finite planning permissions. As John Callcutt observes:

> **'There is no reason why government or other public agencies should not stipulate faster build-out rates when disposing of land for housebuilding**

or within partnering agreements, so long as they can justify any loss of value this may incur.'
Callcutt 2007

Local authorities and HRA reform

Coalition reforms to the HRA, mostly inherited from the previous government, will localise the choice as to how housing debt is serviced, and how quickly. This stands to increase the borrowing potential of local authorities to build new homes, constrained by the debt cap imposed on them under the self-financing clauses of the Localism Bill.

HRA reform will enable a small number of additional council houses to be built, and this opportunity should be taken. The prospect of further such house-building could be increased if local authorities could combine or trade their borrowing headroom (London Councils 2011). It is also possible that financial vehicles such as public private partnerships may be devised to allow local authorities to bring forwards the ring-fenced surplus they will amass in their local HRA over time (amounting to £54 billion approximately, nationally, by 2041) to invest it in building new council housing now (PwC 2011).

3.3 Recapitalise government spending on housing

Summary of suggestions

- Set a single housing strategy and budget across government
- Regulate and negotiate with landlords for lower rents and more reinvestment
- Localise spending on housing, starting in London

Housing benefit (HB) today is both important and useful for 5 million households, responding to growing need in a recession, the way a means-tested benefit should.[9] Nevertheless, a hot topic in current debate is the extent to which the sort of personal subsidy HB offers is politically sustainable, given the way personal entitlements can be exploited in grievance-driven politics. Nearly half of all people in the UK support spending less on HB if it means the money saved could be spent on other things, including paying off the national debt, and this figure only decreases slightly if the consequence would be existing tenants having to move house to a cheaper area (Ipsos MORI 2011). The (relatively invisible) economic subsidy to building social housing does not attract the same sort of outrage. This gives us all the more reason to consider whether government money spent on HB could, over time, be progressively recapitalised, that is, shifted from subsidising people's (often high) rents to building them (affordable) homes.

International comparisons

It may be useful, however, before exploring this argument, briefly to compare the UK approach to HB to the systems in place in other countries. Contrasted with other EU and English-speaking countries, the UK has a high (but not exceptional) level of owner-occupation in its tenure mix, and, until quite recently (with a revival in the PRS), a relatively large social sector. Notwithstanding the difficulty of comparing different social welfare systems, HB (unlike other benefits) in the UK is relatively generous (Kemp 2007). Many countries include an element of housing allowance as part of other (for example, unemployment) benefits, which are then supplemented, if necessary, with a HB equivalent.

9 Although it should be noted that the previous sustained period of economic growth did not see commensurate reductions in HB spend.

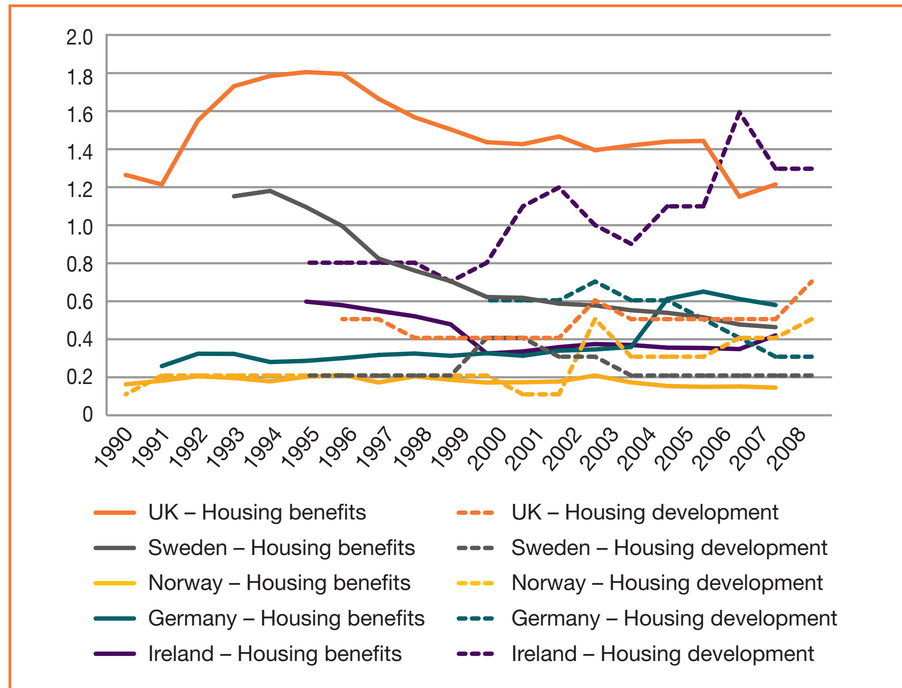
Some operate a 'stepped' housing allowance taper to encourage recipients to seek out lower rents. An assumed contribution – for example, that everyone must contribute 25 per cent of their income towards rent – is common internationally. A number of countries (such as New Zealand) also offer a housing allowance to owner-occupiers. Unusually in the UK, housing cost elements have not been included in the mainstream social security benefit.

Research published by the Department for Work and Pensions (DWP)(Ditch et al 2001) found that, at the time, of the ten overseas countries studied, the Netherlands was the only one, like the UK, to have a larger social rented sector than its private rented sector (although the Netherlands traditionally has less stringent criteria for eligibility for social housing). The amount of discretion afforded to social landlords in setting rents in the UK has been exceptional internationally. The shift (detailed below) of subsidy in the UK over the past four decades away from supporting new building and towards providing social assistance in the form of HB is observable in other countries too (Kemp 2006). Nonetheless, as figure 3.2 shows, the UK is still (and has been for at least 20 years) an outlier in terms of the amount spent by government on personal housing subsidy. That said, many of the quandaries faced by policymakers in other countries are similar to those that confront policymakers here, including how to avoid disincentivising work (which is surely to be the unintended consequence of the introduction by the government of 'flexible tenure'), how to tackle under-occupation in social housing, and how best to target housing allowance.

In the UK, over the last four decades, the balance of public expenditure on housing has shifted away from funding the building of new homes towards subsidising rents for people on low incomes through HB. The key drivers of the rise in HB expenditure have been rising rents and tenure shift away from local authority housing before the economic crash, and increasing caseloads since . This has contributed to a significant reduction in the rate of new house completions at a time of rapid household growth[10] – with negative consequences for the economy, the housing market and public expenditure. There is a strong case for reversing that trend: switching resources from paying people's rent to building them homes. This is a complex proposition, not least because of the many interlocking factors which affect public spending on housing and the nature of the UK housing market. However, in this section we explore some of the issues and options, starting with understanding trends in HB expenditure before looking at possible ways of switching resources to finance new supply.

10 There are, of course, other factors which affect housing supply and the rate of house building, in addition to the level of capital expenditure from the public purse.

Figure 3.2
Percentage of European countries' GDP spent on housing development and housing benefits

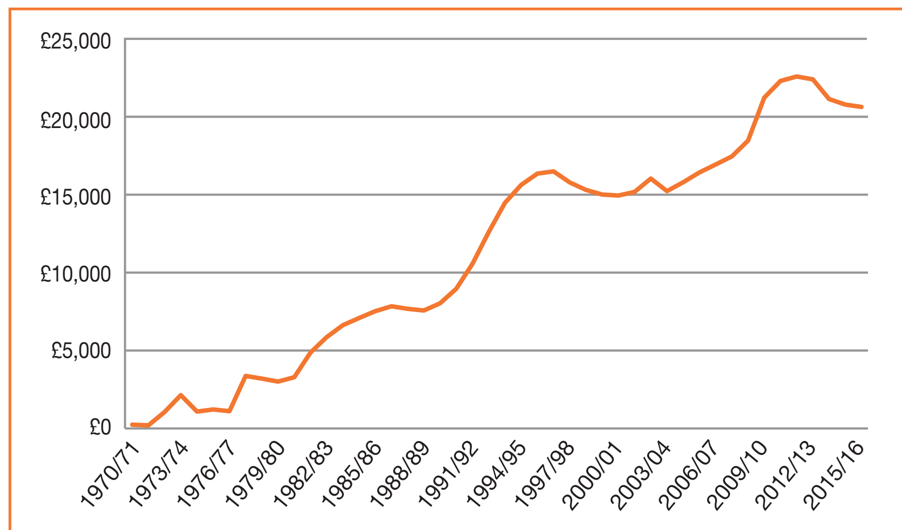


Source: Eurostat

Understanding trends in housing benefit expenditure

Figure 3.3 shows that real spending on HB has been rising, often very rapidly, since the early 1970s,[11] rising from £1.1 billion in 1970/71 to £21.2 billion in 2009/10 (in 2011/12 prices).

Figure 3.3
Trends in housing benefit expenditure, 1970/71 – 2015/16 ('000,000s)



Source: Author's calculations based on DWP benefit expenditure tables[12]
Note: Prior to 1982/83 supplementary benefit also covered rent.

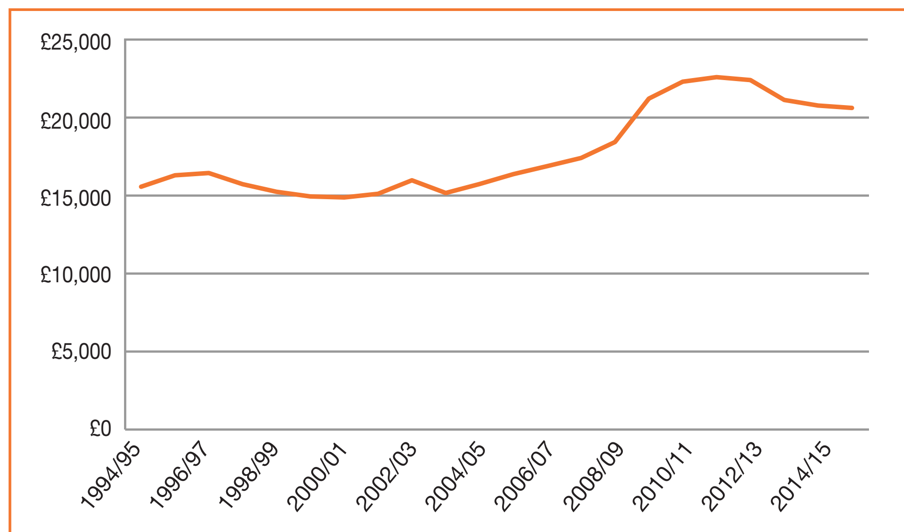
11 The system of national HB was introduced in 1972, before which local authorities had operated their own rent rebate schemes for people on low incomes.

12 Available at http://research.dwp.gov.uk/asd/asd4/index.php?page=medium_term

There is a discontinuity in the data from 1994/95, accounting for what appears to be a slight drop in spending at that point, partly explained by the introduction in 1996 of local reference rents as an upper limit – the basis from which the local housing allowance (LHA) was subsequently devised – when previously there had been only very limited restrictions on eligible rents in the PRS. Therefore it is worth considering trends since then, presented in figure 3.4, which show that spending was broadly flat from the mid-1990s until the first half of the next decade (falling from £15.6 billion in 1994/95 to £14.9 billion in 2000/01). It then rose gently until the recent recession (reaching £17.4 billion in 2007/08) before rising rapidly (as a means-tested benefit ought to in a recession) to reach £21.2 billion in 2009/10.

Figure 3.4 also shows that the government is expecting HB expenditure to peak in 2011/12 (at £22.5 billion) before dropping back over the following four years (to reach £20.6 billion in 2015/16). This is forecast as a result of policy changes made by the current government to reduce HB spending by £2 billion over the next four years. These measures are discussed further below, but it is worth noting that, to achieve this projected fall, there would have to be zero underlying increase in HB spending over that period (from rent rises, tenure shifts or caseload increases).

Figure 3.4
Trends in housing benefit expenditure, 1994/95 – 2015/16 ('000,000s)



Source: Author's calculations based on DWP benefit expenditure tables

Looking beneath these headline trends, it is clear that there is a significant regional dimension to the rising HB bill. London was the region where most HB was spent in 1997/98 (23 per cent of the total spend) and it saw the largest rise over the following decade – up by almost half. This compares to Scotland, where HB spending rose by 15 per cent and Great Britain as a whole, where real spending rose by 34 per cent. By 2009/10, London accounted for 26 per cent of all HB expenditure.[13]

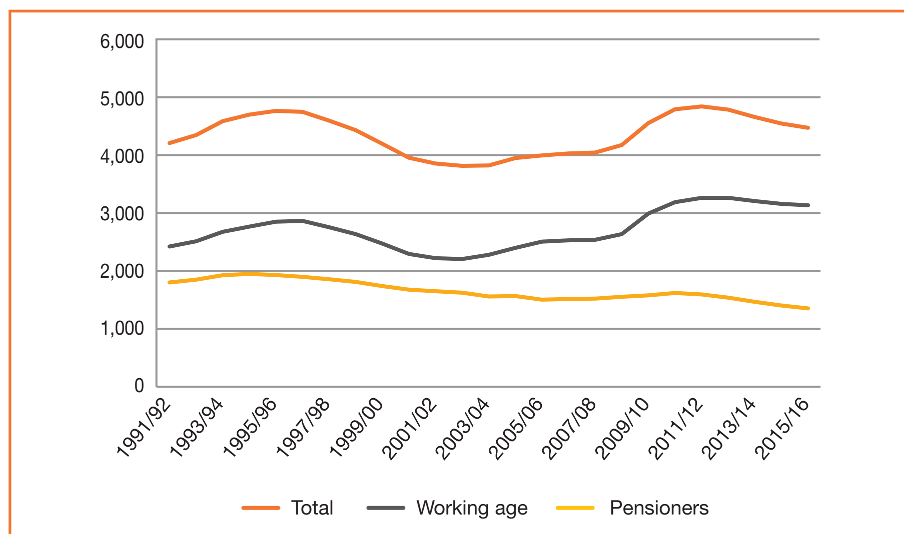
There are four main drivers of levels of HB expenditure: tenure, rent levels, caseload (both volume and composition) and generosity. In practice, these factors are often not independent, with different tenure types reflecting different rent structures and rent levels affecting generosity. They cannot therefore be considered in isolation.

13 Data available at http://research.dwp.gov.uk/asd/asd4/h_tables_budget2010.xls

The first major trend to understand is caseloads. Figure 3.5 shows changes in the number of people receiving HB over the last 20 years. This rose during and after the early 1990s recession, peaking at 4.8 million in 1995/96, before falling back to under 4 million at the turn of the century. Numbers then remained fairly stable until the recent recession, when they jumped by almost three-quarters of a million in three years (2007/08 to 2010/11) – a large rise that has contributed significantly to the rapid rise in expenditure. However, looked at over the long term, trends in the number of people claiming HB cannot entirely account for the uninterrupted rise in expenditure.

The chart also suggests working age claims are far more affected by the economic cycle than pensioner claims, which have been flat, if slightly declining, up to 2009/10. This suggests that population ageing is not playing a major role in rising HB expenditure.

Figure 3.5
Housing benefit caseload, 1991/92 – 2015/16 ('000s)



Source: Author's calculations based on DWP benefit expenditure tables

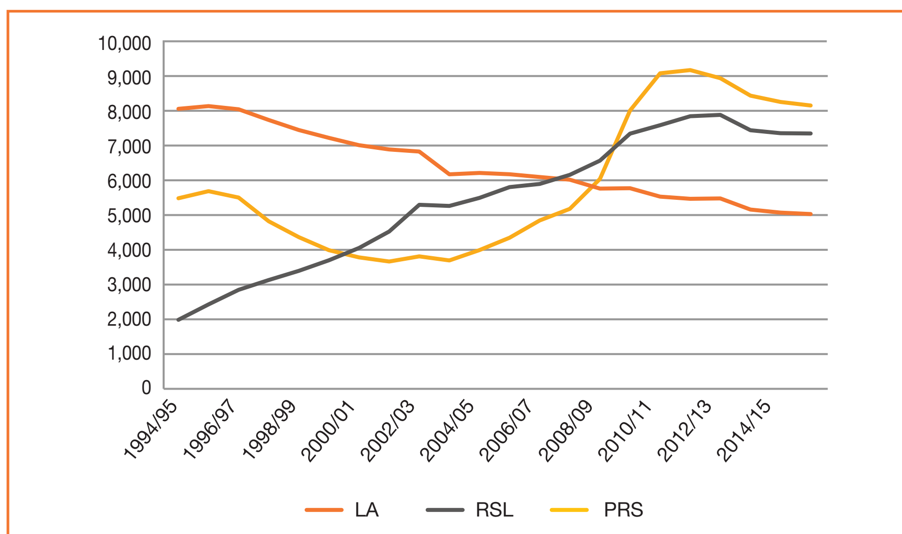
In addition to caseloads, part of the explanation for rising expenditure lies in the very significant shifts in the share of HB going to people in different housing tenures over the last two decades. As figure 3.6 shows, spending on people in local authority social housing has been on a steady decline since the mid-1990s (falling from £8 billion to £5.8 billion in 2009/10). This largely reflects the major stock transfers that have been undertaken by councils over this period, plus generally lower rents for council-owned properties (although in recent years, under rent restructuring, they have been converging with RSL rents, prior to the onset of Affordable Rent). The share of overall HB expenditure going to tenants in local authority housing has fallen from 52 per cent in 1994/95 to 27 per cent in 2009/10.

By contrast, the share of spending on RSL and PRS tenants has risen significantly over the same period. In particular, RSL spending has been on a rapid and uninterrupted real terms rise over the last 15 years, from £2 billion in 1994/95 to £7.4 billion in 2009/10. This reflects stock transfer and generally higher rents, compared to council properties. This has taken the share of all HB spent in the RSL sector from 13 per cent to 35 per cent. Spending in the PRS dropped during the second half of the 1990s from well over £5 billion to a low of £3.7 billion in 2003/04.[14] However, it then accelerated very rapidly, reaching over £8 billion in 2009/10 – a rise

14 Most commentators think this is because trends in the PRS reflect prevailing economic conditions much more than other sectors.

that predates the recession by a number of years. It is worth noting that the share of overall HB spending on PRS tenants has risen only slightly across the whole period from 35 to 38 per cent.

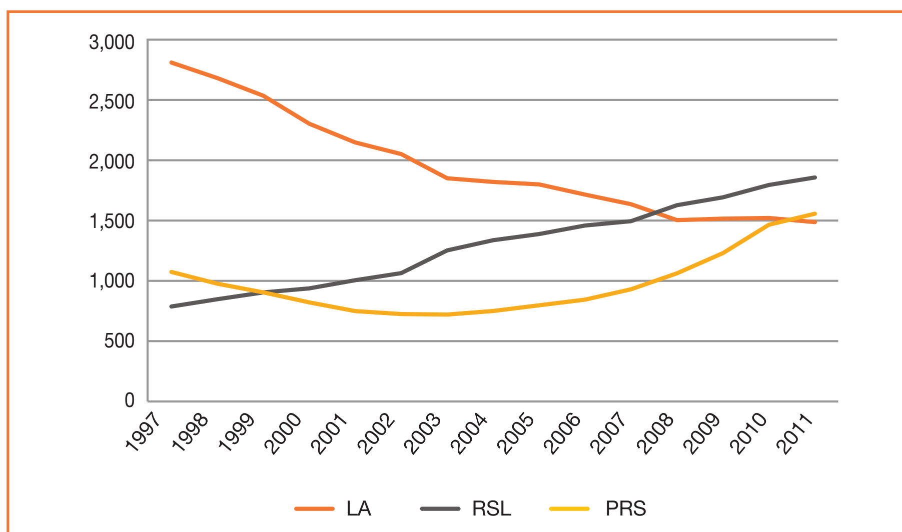
Figure 3.6
Housing benefit spending by tenure, 1994/95 – 2015/16 ('000,000s)



Source: Author's calculations based on DWP benefit expenditure tables

Digging even further into these shifts in spending, figure 3.7 considers trends in caseload by tenure. This shows that local authority caseload has been on a rapid and sustained decline (from 2.8 million in 1997 to 1.5 million in 2011), while the RSL caseload has been on a steady rise (from 0.8 million to 1.8 million). The share of HB recipients in the local authority sector has fallen from 60 per cent to 30 per cent between 1997 and 2011, while the RSL share has increased from 17 per cent to 38 per cent. Reflecting trends in expenditure, PRS caseloads have fluctuated more, declining in the late 1990s before rising over the last few years (by almost half a million since 2008). This suggests that higher caseloads have played a significant role in accelerating HB spending in the PRS.

Figure 3.7
Housing benefit caseload by tenure, 1997–2011 ('000s)

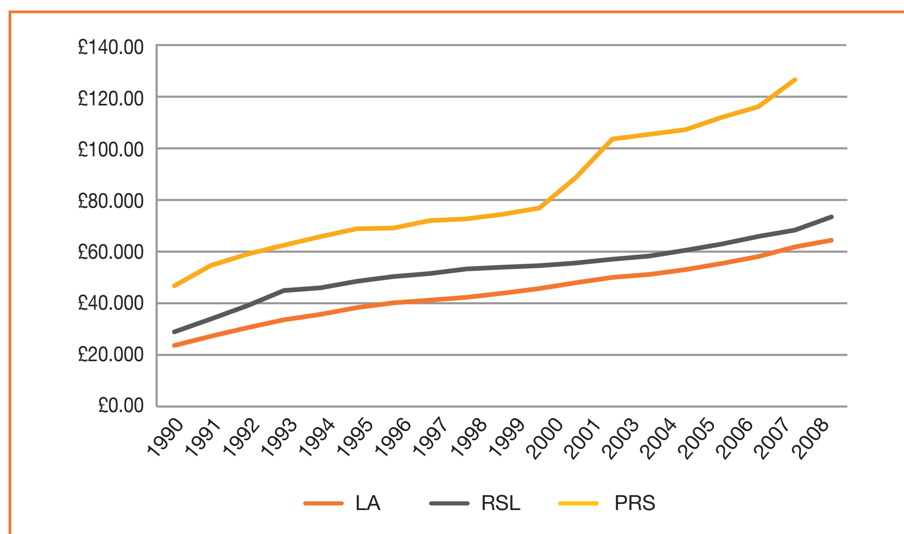


Source: Author's calculations based on DWP benefit expenditure tables[15]

15 Available at http://research.dwp.gov.uk/asd/asd4/h_tables_budget2010.xls

This last point is emphasised by trends in weekly rents by tenure, which show both consistently higher housing costs in the PRS compared to the RSL and local authority sectors and the intensification of this difference since the turn of the century. Between 2001 and 2007, the last year for which there is data, rents in the PRS went up by 42 per cent – compared to 29 per cent in the local authority sector and 23 per cent in the RSL sector. In the social sector, rents are regulated and to a large extent tracked by HB. In the PRS, rent controls were abolished in the 1980s, leading to a period of rent inflation with knock-on consequences for HB expenditure.

Figure 3.8
Average weekly rents by tenure, 1990 to 2008



Source: Author's calculations based on UK Housing Review data[16]

Before concluding this review of HB expenditure,[17] it is important to focus, in particular, on trends over the last three years, which cover the impact of the recent recession. This is the context for current debates about controlling the HB bill and any attempt to shift the balance of public spending on housing.

Spending on HB before the recent recession, while rising, was not 'out of control'. It fell in real terms in 2003/04 (although not, perhaps, by enough), followed by four years of steady £0.5 billion a year increases. However, it then rose by £1 billion in 2008/09, £2.7 billion in 2009/10 and is expected to have risen by a further £1 billion in 2010/11. This would amount to an overall rise of £4.8 billion (28 per cent) over three years. Across this period, spending on local authority tenants falls by £0.49 billion, spending in the RSL sector rises by £1.4 billion, but in the PRS it shoots up by £3.9 billion. This confirms that the PRS has played the overwhelming role in recent rises in HB expenditure. What is far less clear is whether this will drop as the economy picks up, as has been the case in previous cycles.

The data presented here shows that both higher caseloads and rising rents (linked to higher average awards) are important factors in explaining this acceleration in HB spend in the PRS. The overall HB caseload has risen by almost 20 per cent in the three years to 2010/11, having been relatively flat at around 4 million since the turn of the century.

16 Available at www.york.ac.uk/res/ukhr/ukhr1011/compendium.htm and Table 72 at www.york.ac.uk/res/ukhr/ukhr1011/tables&figures/excel/10-072.xls

17 Other factors affecting HB expenditure, but not considered here, are trends in claim duration and the size of families in receipt of HB (with larger families having higher awards).

Indeed analysis of caseload and generosity effects on rising HB between November 2008 and June 2010 reveals that 83 per cent of the increase is accounted for by higher numbers on the benefit (63 per cent PRS, 20 per cent social sector) and just 17 per cent by higher levels of payment (10 per cent PRS, 7 per cent social sector) (Gaffney 2010). It is also worth noting that over a fifth of the rise in HB in 2008/09 and 2009/10 is accounted for by higher PRS spending in London.

As noted above, the government is projecting that spending on HB will peak this year and then begin to fall back – as a result of policy changes (to limit entitlement and generosity) and economic recovery (see figure 3.4). These policy changes include: capping the level of LHA available for different family sizes; setting the LHA rate at the 30th percentile of local rents; reducing deductions for non-dependents; limiting entitlements to reflect family size; and increasing the age limit for the shared room rate from 25 to 35. Government is also projecting a decline in the HB caseload of 321,000 between 2010/11 and 2015/16 (from 4.8 million to 4.5 million).

Taken together, these measures are expected to leave the HB bill almost £2 billion lower by 2014/15 than it would otherwise have been.[18] Between 2011/12 and 2015/16 spending in the PRS is expected to drop by about £1 billion and in RSLs by about £0.5 billion. While PRS spend might be expected to drop if employment does rise in the coming year, the expected trend in the RSL sector is more surprising given continuing growth in the size of this sector and the government's decision to allow housing associations to charge (higher) 'affordable rents' to new tenants, who are unlikely to have come from the more expensive PRS.

In conclusion, this analysis of trends in HB expenditure and caseloads shows that:

- spending on HB has been on an upward trajectory, in real terms, for the last 40 years
- it was relatively flat from the mid-1990s, rising steadily after the turn of the century and then accelerating rapidly over the last three years
- higher expenditure cannot be accounted for entirely by rising caseload, which fell from the mid-1990s, while HB spending rose in real terms
- during this period, the rising HB bill was the result of stock transfer from the LA to the RSL sectors and then rising caseloads (and rents) in the PRS
- HB expenditure has risen very rapidly in the last few years, during the recession. This has been largely caused by a significant spike in caseloads, especially in the (more expensive) PRS
- the government is expecting HB spending to peak next year and then fall – the result of policy changes to restrict entitlement and declining caseloads
- HB spending is regionally skewed, with London accounting for over a quarter of all expenditure and seeing the largest rise of all regions over the last decade.

The switch from 'bricks and mortar' to rent subsidies

Underpinning all of the factors discussed above – tenure, caseloads, rents and generosity – is the shifting of public expenditure on housing from 'bricks and mortar' (principally capital investment in new homes) to subsiding housing costs (largely rents) for people on low incomes. In 1975, more than 80 per cent of housing subsidies were on the supply side – in bricks and mortar – and were intended to promote the provision of affordable

18 This projection does not take account of any passported costs, such as a rise in homelessness which could arise from these measures.

homes; by 2000, more than 85 per cent of housing subsidies were on the demand side, reducing housing costs for those on low incomes through HB (Stephens et al 2005).

Ditch et al (2001) found that the shift from 'bricks and mortar' to personal subsidies is common across Western countries. However, they also identify significant differences in the way rents are designed and structured:[19]

- 'Differential rents' – this is where rents are set as a proportion of tenants' incomes, not the costs or characteristics of the dwellings. Higher rents are charged for those on higher incomes (up to market value). Such schemes operate in Australia, Canada, Ireland, and the United States – and Britain prior to the introduction of the national HB in 1972. Two obstacles to such an approach are the difficulty of administering it and the danger of creating work disincentives.
- 'Property-based rents' – this is where rents relate to the size, quality and location of the property. In the Netherlands, rent rises are set nationally, while in Sweden they are set through regulated social landlord and tenant negotiations (which reflect difference between dwellings but not necessarily market value).

In their calculations, Ditch et al define 'bricks and mortar' spending as grants, low interest loans and tax breaks to developers and landlords – and there are a number of ways of considering the relevant comparison today. For a start, by 2014/15 the government will be spending £20.7 billion on HB compared to the total DCLG capital budget of £2 billion.[20] This includes a 63 per cent real terms cut over the spending review period in the budget for the National Affordable Housing Programme, administered by the HCA to support the building of new dwellings (NHF 2010).

An alternative approach is to consider gross investment in social housing, trends for which show a steady decline from the late 1970s to the end of the 20th century, followed by a significant rise up to 2007/08. By way of comparison, in 1999/2000 the spending review committed the government to £4.8 billion of investment in social housing over the next three years, while in that year alone £11.1 billion was spent on HB. In 2007, another spending review committed the government to £8.6 billion investment in social housing over three years, but in the following year alone the HB bill reached £17.1 billion.

This shift in public expenditure from bricks and mortar to HB has contributed to a reduction in the rate of house-building, leading to a shortage of new homes at a time of rapid growth in household numbers (driven by a rising population and changing household formation). This shortage, in turn, has resulted in:

- a housing bubble and macro-economic instability
- unmet housing need and unfulfilled housing aspirations
- a spiralling benefits bill and weak work incentives.

The options for reversing this shift are somewhat restricted by this government's already announced policies to: reduce the HB bill to pay down the deficit rather than to invest in new social housing and (somewhat contradictorily) to allow RSLs to charge 'affordable rents' (up to 80 per cent of the market rate) to provide them with a higher rental stream against which to borrow to fund new building. For tenants on HB, this higher rental stream will be funded by higher HB.

19 As at 2001.

20 Not all the DCLG capital budget is spent on housing.

To address the problem of under-supply, the government is also proposing to match the council tax raised by local authorities on newly built dwellings for the first six years, to provide an incentive for them to support new developments. However, these policies are not likely to meet the challenge of financing the new supply at the necessary levels – and they will not reverse the trend of public expenditure on housing increasingly being routed through HB rather than 'bricks and mortar'.

Resetting government spending

Given this context, what are the options for setting a new course which seeks to switch this balance of public spending back over time?

Set a single housing strategy and budget across government

For many years, coherence in housing policy has been undermined by the different policies and competing objectives of HM Treasury, DWP and DCLG. Not only has this allowed the drift in expenditure described here, but it has prevented an integrated approach to the government's role in shaping the housing market. For example, social housing is funded both (directly) by grants from DCLG and (indirectly) through HB from DWP. However, the interaction between these sources of funding is rarely considered.

The government's overall budget on housing – covering tax breaks, capital investment and benefit spending – should be drawn together to drive a single policy agenda, including the goal of shifting resources from paying people's rent to building them affordable homes. If the Treasury were to report on all government spending on housing in one place, informed decisions on important trade-offs could replace policy drift. This would signal intent and ensure ministers and officials take account of the interlocking impacts of housing policy decisions (like the impact of 'affordable rents' in the RSL sector on the HB budget).

Consideration should also be given to the way the government's rules for annually managed expenditure and departmental expenditure limited funding have driven the shift in public spending. Allowing HB to 'take the strain' has contributed to lower house building (especially in the social rented sector), increasing reliance on the PRS (with higher rents), weakening work incentives and driving up the HB bill. Over time, the goal should be to direct public expenditure in support of a positive cycle of higher house building, stable rents, increased employment and a lower HB bill.

Regulate rents

In the social sector, the generosity of HB is very closely linked to the level of rent. For people on out of work benefits – an increasing proportion of those in socially rented properties – HB simply covers the entire cost of the rent, with claimants often unaware of the level of either their rent or benefit. Rents in the RSL sector are already set to rise towards 80 per cent of the market rate – and even LA rents have been rising steadily in recent years (partly the result of a deliberate policy to reduce the big differences between sectors, seen as distorting). These trends reduce the scope for controlling the HB bill by regulating rents in the short term.

However, there is a strong argument for developing a clearer and more transparent system of rent setting in the social sector – as occurs in several other European countries (who have national rent setting arrangements). This would not only give the government greater control over a market they are significantly subsidising (not just through benefit payments), it would ensure that the impact of rent rises on public spending were debated and provide a forum for greater leverage of HB funding in support of wider housing goals.

Such rent setting arrangements could take place at a local level, within a nationally agreed framework, to reflect local conditions.

In the PRS, rents are unregulated, although there are limits to the amount of subsidy available for people on low incomes through HB. The LHA has created a more transparent system for deciding on this maximum – which is already being reduced significantly under the government's planned caps. These caps are intended to act as de facto regulation of PRS rents in the HB submarket (assuming, perhaps boldly, that landlords will reduce the rents they charge accordingly), but there may be an argument for a wider regulatory intervention, to prevent upward pressure from the rest of the market (and to stop HB tenants and landlords being cut adrift from the rest of the market). Much higher rents in the PRS certainly amplify the impact of tenure shifts – which will happen if caseloads rise without sufficient LA or RSL properties to accommodate people.

Evidence suggests that the impact of the LHA caps will bite most in London, where rents are markedly higher than elsewhere. One option would be to increase the cap in London, but reduce it further elsewhere – which could generate additional HB savings. However, the key issue would be whether such resources were kept within the housing budget to fund new supply, or simply used to pay down the deficit.

Reduce HB expenditure
In addition to regulating rents, the government could consider further steps to reduce the HB bill, to release money to finance new supply. There are a number of options:

- Entitlement to support with rent could be provided through a 'stepped' taper, to discourage the use of expensive properties. At present, HB covers 100 per cent of rent costs up to a certain limit and nothing beyond that. An alternative would be to lower the level of rent that will be 100 per cent covered by HB, but introduce an additional rental band which HB would cover at 50 per cent (with a further, final, cap above that). This would create more of an incentive for people to seek out lower rents, as a greater proportion of their costs would then be covered (but at lower overall cost to the state) (Kemp 2007). This, however, would only work if there were in fact cheaper properties available in the area for tenants seeking them.
- To create greater control over spending and prevent the drift described above, government could set a fixed envelope for HB, effectively turning it into a departmental expenditure limited budget as part of an integrated overall housing budget across government, reported on together in one place in government accounts. Ministers would then be forced to account for and take action if the expenditure 'ceiling' is at risk of being broken – creating a check in the system and encouraging alternative housing policy measures that would keep the HB budget down.

Clearly the difficulty with all these measures is that HB is enabling people to pay their rent now, so any reduction in the level of spend creates a problem, at least in the short term. However, it would be far easier to justify measures to restrict HB expenditure if such resources were set to be diverted – as part of a 'grand bargain' – into funding new supply.

Deal with PRS landlords
Spending on HB in the social sector not only subsidies the rent for people on low incomes but also, if indirectly, provides an income stream to fund the building of new supply. However this is not the case in the PRS, where HB expenditure simply covers immediate rental costs – and provides an income stream to private landlords. In the social sector, rents are lower, work incentives are better (in theory at least) and income is (at least

partly) reinvested in building new homes. By contrast, in the PRS, rents are higher, work incentives are worse and income is not (generally) reinvested in building new homes. In short, HB spending in the PRS not only costs more per person but it buys the state less.

Therefore the government should consider ways to leverage greater impact from the HB it spends in the PRS – while not significantly constraining the supply of private landlords willing to rent to tenants on HB. A framework could be established for councils to enter into long-term deals with local landlords that would see them guarantee tenants (and therefore a rental income stream, perhaps paid directly) in return for lower rents – and greater security of tenure for individuals and families. This would create, in effect, hybrid 'social private landlords', with deals ideally done at scale to help to put the PRS on a more stable footing. There are precedents for such deals in London, where many local authorities practise private sector leasing already, as well as in arrangements for temporarily housing the homeless, although to date these schemes have not seen significant reductions in rent.

The savings generated from this reform could be diverted directly into funding new supply. However, an alternative approach would be to make the newly released resources available to private landlords to finance new building, including borrowing against this income stream. This would have the added benefit of creating an incentive for private landlords to participate in contracts with councils based on lower rents and more secure tenancies, because it would enable them to invest in (and benefit from) new supply. Landlords who unreasonably refused to participate in the scheme could be disentitled from receiving HB – or local authorities could be enabled to compulsorily purchase properties to increase the supply of social housing, where rents are lower.

In several European countries, including Germany, 'bricks and mortar' subsidies are provided to private landlords (as well as to the social sector). Under these arrangements, 'social housing' is a term applied to dwellings provided with the assistance of subsidy, and which are subject to time-limited contractual obligations on rent levels, standards and allocation arrangements. Once the subsidised loans have been paid off, the private landlords are free of their contractual obligations and the dwellings effectively pass from the 'social' to the 'private' rented sector.

Allow social landlords more freedom to use their rental income to finance new supply
Social landlords are currently funded (directly) through grants and (indirectly) through HB. This creates an opaque system of funding, with little coherence and co-ordination across the two. Reforms to national budgets would help to clarify the resources available to social landlords and on what basis they receive them. This would allow more strategic decisions to be made about getting the right balance between grants and HB – and would enable the funding of new supply.

Steps have been taken along this road, through the planned reforms to the HRA, which aim to bring greater transparency and fairness to the funding of social housing. However, they also provide an opportunity to advance significantly the ability of local authorities to use the rental income on their properties to borrow against to fund new affordable housing (in just the same way as 'affordable rents' are aimed to help RSLs build more homes).

The government might also consider, notwithstanding questions of state aid, taking a tougher line on what it gets for the funding it provides through HB in the social sector. It could start by making a clearer assessment of what the rental stream provided through HB is paying for – distinguishing between maintenance of existing properties and

resources available for new builds. Councils and RSLs could be required to set aside a certain proportion of HB revenue for increasing their stock of housing. The revenue from any further sale of council houses should certainly be used to fund new supply.

Localise spending on housing, starting in London

A more radical approach to the issue of integrating housing expenditure (and regulation) across existing funding streams would be wholly to devolve public spending on housing to local areas. This could be to the council or to a local consortium of the local authority plus local RSLs and PRS landlords. This body could be given responsibility for spending on HB, LA grants and funding for new houses (currently administered by the HCA) – with a fixed annual or three yearly budget based on local population characteristics.

This would give local areas the ability to make decisions about how to prioritise spending between subsidising rent and financing new supply – based on the local housing market and local need. It would, for example, give local areas much greater scope to increase the supply of social housing (with lower rents and lower HB), including through purchasing properties. Such an approach would create a sharper financial incentive for councils to keep down rents and increase employment, because they would stand to gain from any reduction in HB entitlement and face the costs of any increase. How such a system would cope in a recession would need to be carefully worked through.

Consideration would also have to be given to how such an approach would fit with the universal credit (UC), but one option would be to build a flat rate element of support with housing costs for everyone into the UC, while diverting the rest into the local funding pot. HB will be an identifiable component of UC, reflecting housing costs, which differ according to tenure and region. There may well be mileage then in exploring how much of the housing component of UC is really to do with housing, and how much is basically out-of-work or low-income benefit, and then investigating the idea of localised housing top-ups in more expensive areas, administered locally. This would effectively separate the two functions HB performs: housing affordability (which could be better served by a separate, better tapered instrument for demand-side housing allowance) and income maintenance (for which DWP is rightly responsible).

The most obvious starting point for such an approach would be London, where the mayor already has powers over planning, land use and capital spend. By adding in HB (or a top slice, beyond the basic UC amount), he would be able to leverage considerable resources to secure finance for new supply. This would give him significant powers to manage the housing market in the capital strategically – including the spiralling HB bill and the chronic lack of affordable homes.

We are currently stuck in a negative cycle, delivering poor value for money for the taxpayer: not enough housing supply, rising house prices and rents, poor work incentives, unemployment and an ever-rising HB bill. We need to aim for a positive cycle, delivering better value for money: higher house-building, stable rents, better work incentives, higher employment and a lower HB bill.

No shift back from HB to bricks and mortar can be effected overnight: there are huge transitional issues. But IPPR is exploring the possibility in the context of there being little other prospect of a substantial increase in government capital spending on housing over the years ahead. We will therefore be doing further work to model and illustrate some of the above options for reducing HB expenditure to build more homes as our programme of housing research progresses.

4. TWO OTHER IDEAS IPPR IS EXPLORING

In the case of these two further ideas, where our thinking is at an earlier stage, we outline the core argument and then signpost the reader towards a fuller treatment in forthcoming, dedicated IPPR reports.

4.1 Create a National Investment Bank

Summary of suggestions

- Expand the new Green Investment Bank into a fully-fledged National Investment Bank which invests – among other things – in new housing.

The need to increase housing supply is one of many reasons why the Green Investment Bank which the Coalition government has announced, currently too narrow in its remit (low-carbon, renewables and energy efficiency), should be expanded into a fully-fledged National Investment Bank (NIB), as elsewhere in Europe, to invest capital in national infrastructure, such as housing. This would enable the state's resources to be used to borrow cheaply and guarantee loans to facilitate private house-building, inverting the principles of the private finance initiative. Corporate customers would apply to their own bank for financing; the bank would then forward the application to the NIB, which would then assess the project for 'fit' with its strategic priorities. If approved, it could then re-finance the loan at a favourable rate because of its government guarantee and its access not only to capital markets but also to federal budgets, raising large funds on the commercial markets backed by a smaller capital base provided by the state (Nash and Lent 2011).

The UK is a country with low investment rates (17 per cent gross fixed capital formation over the past decade) compared with similar European countries such as Germany (19 per cent) and France (21 per cent)(Holtham 2011). It is bottom of the league in the G7 for business investment as a percentage of GDP. It is ranked 33rd out of 139 countries for overall infrastructure quality, placing it behind most industrialised economies (WEF 2011). The risk is that this situation will get worse over the coming years. As a result of the 2010 spending review, government departmental capital budgets will fall from £51.6 billion in 2010/11 to £40.2 billion in 2014/15 – a cumulative real decline of 29 per cent. More direct state investment is a characteristic of comparable countries with more investment in their infrastructure. For example, France has a history of large-scale strategic investment funds run by the state, and Germany a long record of public and private long-term or patient capital invested in infrastructure, including rented homes (Housing Forum 2009). State investment to provide marketed services can strengthen infrastructure and support demand while not adding to the burden on the future taxpayer and creating a largely self-financing deficit.

While the Nordic Investment Bank, based in Finland, has invested in greening existing property,[21] the European Investment Bank,[22] the KfW bank in Germany[23] and the Development Bank of Japan[24] have all financed new house building. Lord Skidelsky has argued that a UK NIB should too.[25] Business secretary Vince Cable has argued the case

21 http://www.nib.int/news_publications/759/nib_loan_to_pohjola_to_improve_housing_sector_s_environmental_impact

22 http://www.eib.org/about/press/2011/2011-053-espana-el-banco-europeo-de-inversiones-y-el-ministerio-de-fomento-suscriben-un-acuerdo-para-financiar-vivienda-protegida-en-alquiler-en-espana.htm

23 http://www.kfw.de/kfw/en/KfW_Group/Press/Latest_News/PressArchiv/bis11.2005/Pressemitteilung22953.jsp

24 http://www.dbj.jp/en/service/finance/asset_finance/index.html

25 http://www.skidelskyr.com/site/article/a-way-out-of-britains-growth-dilemma/

for a National Infrastructure Bank in the past[26] and it was included in the Liberal Democrat manifesto at the last general election.

IPPR is currently performing further research on the prospect of a UK NIB, for publication in 2012.

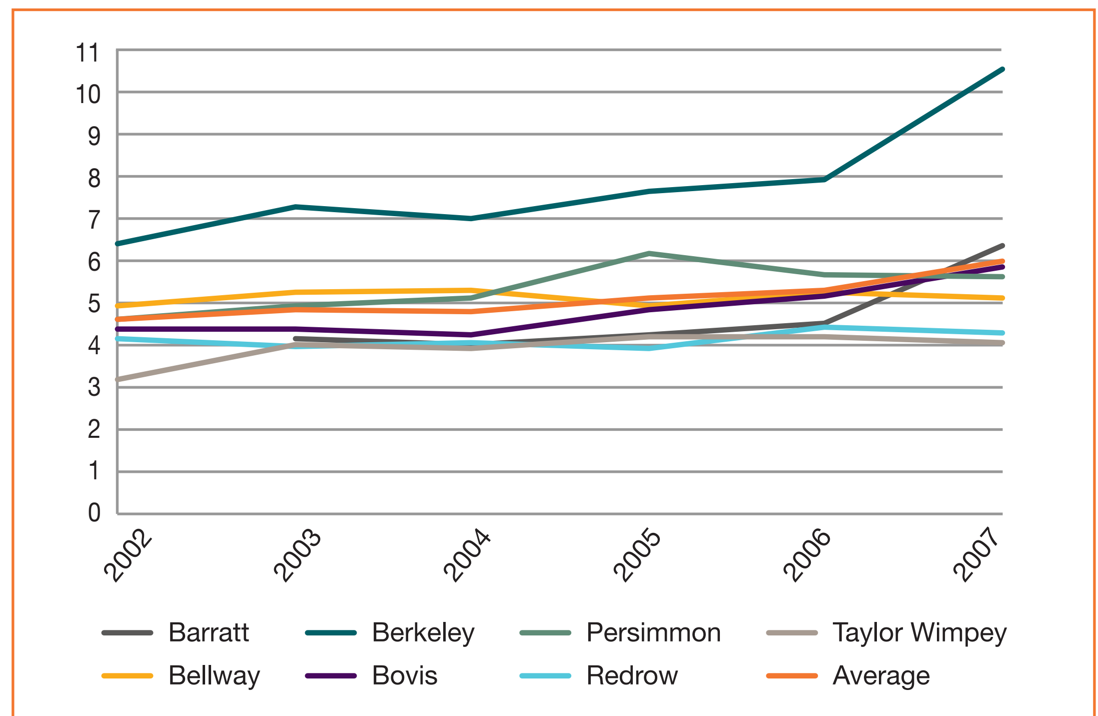
4.2 Reform the development industry

Summary of suggestions

- Structural reform of the development industry to ensure that available land is actually developed.

Freeing up land for development through planning and other reforms (see above) is of limited use unless developers are prepared to develop it. The six or seven major developers in the UK, sometimes described as a 'cartel' (Mathiason and Connon 2005), make large profits on small volumes, crowding out choice and competition, and so creating chronic inelasticity in supply which exacerbates dysfunctionality in the market. Their focus is on acquiring land, for which they compete, and so it is in the acquisition of land that they have focused their innovation. Once they have acquired the land, too often they bank it, as opposed to building on it, as demonstrated by their declared holdings, shown in figure 4.1.

Figure 4.1
Reported land bank in years, 2002–2007



Source: KPMG 2008

26 http://www.libdems.org.uk/speeches_detail.aspx?title=Vince_Cable_launches_proposals_for_a_National_Infrastructure_Bank&pPK=441f7ef6-5e78-44b4-888b-c7115c191479

Developers deliberately holding land out of productive use create an artificial shortage, driving up prices, while they trade in empty sites. Competitive pressures need to be introduced into the industry. It may be 'answerable only to its investors and shareholders and not the public interest' (Callcutt 2007), but, as Winston Churchill remarked in the House of Commons on 4 May 1909, 'the immemorial custom of nearly every modern state, the mature conclusions of many of the greatest thinkers, have placed the tenure, transfer, and obligations of land in a wholly different category from other classes of property'. Developers must be encouraged to develop. Since the crash, the government has been bailing these companies out, recapitalising them through the likes of Home Buy Direct, but, as with the bankers, what should be the quid pro quo? Their current balance sheet problem – they have too much over-priced land on their books – must not be allowed (as it was after previous recessions) to lead to levels of house-building stagnating at their current low in the period ahead. Structural change – even 'creative destruction' – may be needed in the sector to get houses built.

IPPR is currently researching development industry dynamics further, with an eye to reform. It will publish its findings on this subject in winter 2011.

CONCLUSION

The current rate of house-building in England is insufficient to keep pace with demand. If the housing crisis our country faces is to get better, not worse, then this needs to change. Government policy, as it stands, is not up to this task. Various ways have been suggested that finance might be found to increase housing supply: we have surveyed them briefly here. But we at IPPR are developing thinking in three particular areas that we think offer genuine hope:

1. **Institutional investment, while no panacea and often overstated, ought to play a part in the mix.** Here, it is relative, not absolute, returns that are key: investors will focus on how the return on residential property sits along a range of asset classes. Offering investors – most likely domestic pension and insurance funds – rental guarantees, free land, risk-sharing, minimal maintenance costs and effective portfolio management may help to unlock such investment. We need to build on the limited precedent we have in the UK and the many examples elsewhere in Europe. In particular, local authorities should explore the possibility of investing their own pension funds in building new housing, as some of them are now beginning to do.
2. **Local authorities are potent actors in this field and should take more of a lead.** They should free up their own land for developers in return for equity, thereby securing public benefit from future market appreciation. They should also put pressure on others to develop private land, adopting a 'use it or lose it' approach. And they should take the house-building opportunities afforded by HRA reform. Land auction pilots should also get under way.
3. **Central government needs to recognise that the demand-side subsidy system we have shifted towards produces a weak supply-side response.** That shift needs to be reversed, which will not be easy, and will take a long time. It will mean, in part, either getting more out of what government puts into the private rented sector, or getting people out of it and into the social sector, where our money buys us more. Introducing a single housing strategy and budget across government would help, bringing policy coherence and a real focus on building more homes. Perhaps we should reconsider the classification of HB as annually managed expenditure and capital investment as departmental expenditure limited, as the status quo encourages the drift we have seen towards an over-emphasis on HB. A stepped taper could be introduced for HB, so that 100 per cent of rent is only covered up to a certain level, after which coverage is only partial, to encourage people to seek out cheaper properties. We could aim for a framework to support long-term deals struck by local authorities with landlords to guarantee rental income in return for lower rents and greater security of tenure – basically, adding some conditionality to LHA – with the money released directly funding higher supply. Or, more radically, we could localise all housing expenditure, starting in London, integrating supply-side and demand-side funding, devolved to a local partnership with fixed three-year budgets. This would provide a local incentive to reduce the HB bill and to maximise resources for new homes. The mayor of London already has planning, land-use and capital spending powers: adding HB in would increase his leverage. The universal credit could feature a flat-rate housing addition within the main out-of-work benefit which could then be supplemented with a variable, localised housing support top-up.

Finally, we have indicated two other areas that we think may be particularly fruitful to explore – areas in which we will be publishing dedicated papers in the coming months:

4. **The nascent Green Investment Bank could be expanded into a fully-fledged National Investment Bank** which, among other infrastructure, should invest in

building new homes. The European Investment Bank already does this, as do the equivalents in Germany and Japan.

5. **We should grasp the nettle of development industry reform.** We need to find ways to introduce competitive pressures into the development industry to encourage developers to develop, rather than competing to acquire land and then banking it. The status quo needs shaking up: the big six developers enjoy large profit margins while building too few homes and sitting on land that ought to be built on. Government has done a lot since the crash to help the industry out – it should be asking for more in return.

IPPR will be doing more work to develop these ideas as its programme of housing research proceeds. Meanwhile, we hope government, as it refreshes its housing strategy, will find these suggestions useful.

The next in this series of IPPR briefing papers will be about how to use the housing stock we have as efficiently, effectively and equitably as possible. Among other policy questions, it will address how we might fill empty homes, tackle under-occupation across all tenures and allocate the scarce resource that is social housing as fairly as we can.

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