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HOUSING, MORTGAGE FINANCE AND THE BRITISH ECONOMY

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1. INTRODUCTION

This discussion paper is an attempt to describe and contextualise the complex and significant role that the housing sector plays in the British economy. Throughout the paper, three criteria are emphasised.

- How efficient are housing sector arrangements in terms of distortion-minimisation and relative cost of provision?
- How fair is the British system in terms of progressivity, in terms of discrimination and in terms of access to housing resources?
- What impact do the housing and mortgage sectors have on the performance and the capacity of the British economy?

If the chief aim of the paper is to provide the reader with a grasp of the key housing finance, economic and policy debates emerging in Britain at a time of re-assessment of the benefits of owner-occupation and a continued downward pressure on public spending on housing, what are the main objectives of the paper? First, the paper will locate the housing sector within the context of the British economy, setting out the two-way relationship between housing and the aggregate personal sector. Second, it will examine the causes and consequences of financial deregulation, primarily in the owner-occupied sector but also, where relevant, to the funding of rented housing. Third, it will examine housing policy issues in three ways - by setting out the historical development of tenure, fiscal and building policies; and, by examining the recent past which has marked a period of rapid change in policy objectives and instruments

One of the most striking features of housing in Britain is the way that in recent years the ‘housing question’ has climbed up the political agenda after several years of relative obscurity. There are several reasons for this, notably, the spectacular boom and bust of house prices and the subsequent collapse in the previously high-volume owner-occupied market. Second, the Government has reversed earlier policies and has begun to dismantle previously generous tax reliefs and social security mechanisms for owner-occupiers. Third, the declining fortunes of the owner-occupied market has meant disaffection with economic policies and, since the owner-occupied sector consists of two-thirds of the electorate, the fate of the housing market is increasingly bound up with the electoral fate of the Government. Finally, the most well-known British housing policy of the 1980s and 1990s, the selling-off of council houses to sitting tenants at massive discounts, was premised on a successful owner-occupied sector and economy. Now many of these properties are unsellable and the social sector has not seen sufficient replenishment of its stocks of below market rented housing.

In addition to the political arguments, housing has risen as a priority in terms of social issues. The social rented sector is increasingly populated by the unemployed, economically inactive, disenfranchised. Poor health, fear of crime, benefit-dependence and poor housing coalesce in spatially-separated housing estates. Net housing need is estimated at 100-110,000 units of affordable housing per annum for the next ten years; yet the system produces less than half that amount of primarily housing association properties. Disrepair is not the exclusive concern of the public sector, although damp and serious structural problems of long term under-investment are major problems in urban Britain. At the same time, special needs housing is under increasing financial capacity problems to meet the needs arising from Care in the Community - a series of policy initiatives which have moved the funding and management of care facilities to local government with a preference to non-institutional residential care. Alongside this issue sits the question of the funding of long term care for Britain' ageing population. This is just one of the ways in which the extensive means-tested social security system impinges on housing, labour market and savings choices by households.

These problems and difficulties are, of course, in no way unique to Britain. Many countries face similar or more intense problems to do with affordability, housing and capital shortages, social exclusion and inefficient policy-making. Britain's example is interesting because it has a number of relatively idiosyncratic features: a relatively high level of owner-occupation but at the same time, a very small level of private rented housing; a continuing domination of social housing by council housing; a wholly deregulated and highly efficient mortgage market; a predominately speculative volume housebuilding industry alongside a highly price-competitive contracting construction industry; a unique system of providing personal housing subsidies through ex post social security; and a disorganised system of pricing and funding social housing. Many other housing systems share one or two of these features; none other possess all of them.

What is the structure of the paper? Section 2 examines the recent history of the UK economy, providing context for the subsequent discussion of the housing sector. Here, the focus is on the structure of the economy and the recent performance of the key macroeconomic variables. It then goes on to look at both aggregate and micro policy themes as they have emerged in the 1980s and 1990s. The section finishes by linking future economic policy questions to the possible ways that the housing sector impacts on and is impacted upon by the national economy.

The third section is an overview of the British housing system. It begins by setting out historical tenure patterns, moving on to look at the peculiar features and trends within the building sector. This historical component is completed with a brief synthesis of policy developments up to 1979. The remainder of this section looks at subsequent policy developments and attempts to set out a framework for understanding the pricing, affordability, taxation and subsidy of housing across tenures.

The fourth section examines the relationship between the housing sector and the economy. What were the causes and consequences of the boom and bust in the British housing market? How is housing market instability to be explained and what role did mortgage market deregulation play in creating these difficulties? Having analysed these issues, the section concludes by developing a stylised relationship between the housing sector and the economy and then suggesting implications for future economic and housing policies. The final section summarises and concludes.

2. THE UK ECONOMY CONTEXT

The post war period up to the late 1960s in the UK has been characterised as the golden era of the mixed economy. The Labour Government of 1945-51 significantly increased the size of the public sector by nationalising key industries and boosting the size and scope of the welfare state. Up to the early 1970s cross party consensus for Keynesian counter-cyclical economics and a mixed economy prevailed. The UK economy began experiencing deindustrialisation by the 1960s (Buxton et al. 1994 p346) when the share of employment in manufacturing peaked and employment in the service sector, especially, health and education, increased. The restructuring of the UK economy away from manufacturing and towards the service sector since 1979 has been more marked than in the other G6 countries. By 1983 the UK, for the first time, recorded a deficit on manufactured goods.

Economic performance on four key macro variables is described in figure 1. Taking the period 1980 to 1994, real growth (GDP) has fluctuated from more than -2.0% to as much as 5% in the course of two economic cycles. Unemployment has twice in this period exceeded 10%, falling below 6% just once since 1981. As with other economies, the story on inflation is generally better with double digit inflation last recorded in 1981. The most recent experience has been of inflation in the 1-3% zone since 1993. Interest rates, along with inflation critical to mortgage finance, have been through two cycles, peaking in 1981 and 1989. The rest of this section looks at macroeconomic themes in a little more detail.

GDP growth over time

There has been long standing concern over the relative decline of the UK economy compared to the leading economic nations and its lack of international competitiveness (Buxton et al 1994 p33). Using Gross Domestic Product (GDP) per Capita as a broad measure of relative living standards, we can see from figure 2 that the UK's position in 1990 placed it at the bottom of the G6 league table. Allied to a relatively poor GDP per Capita, the UK economy is characterised by *volatile* growth rates. The cumulative effects of permanently lost output during recession compounds the low growth trend.

Figure 1: Key Economic Trends

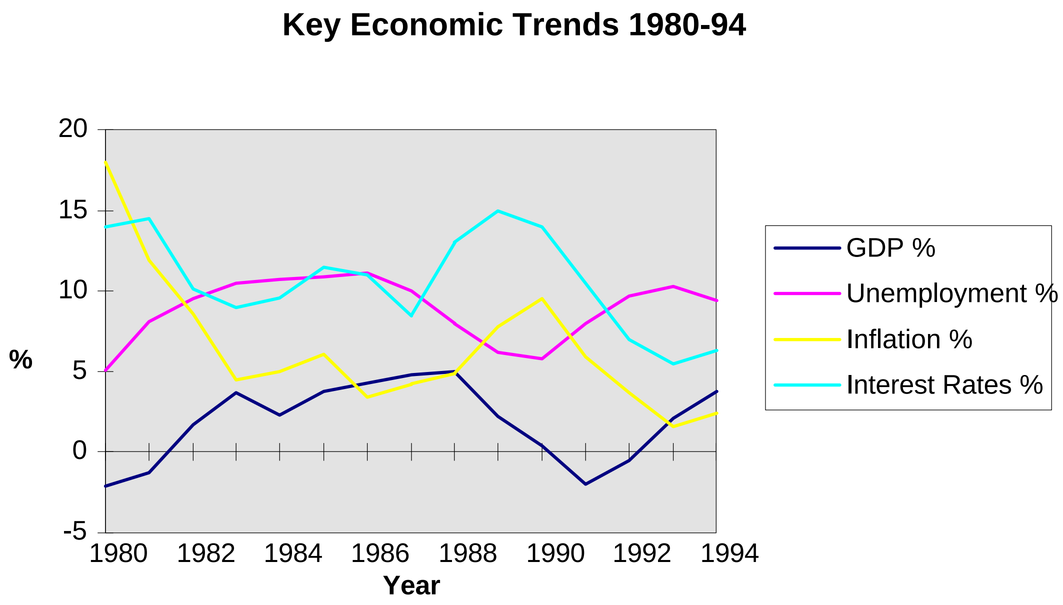
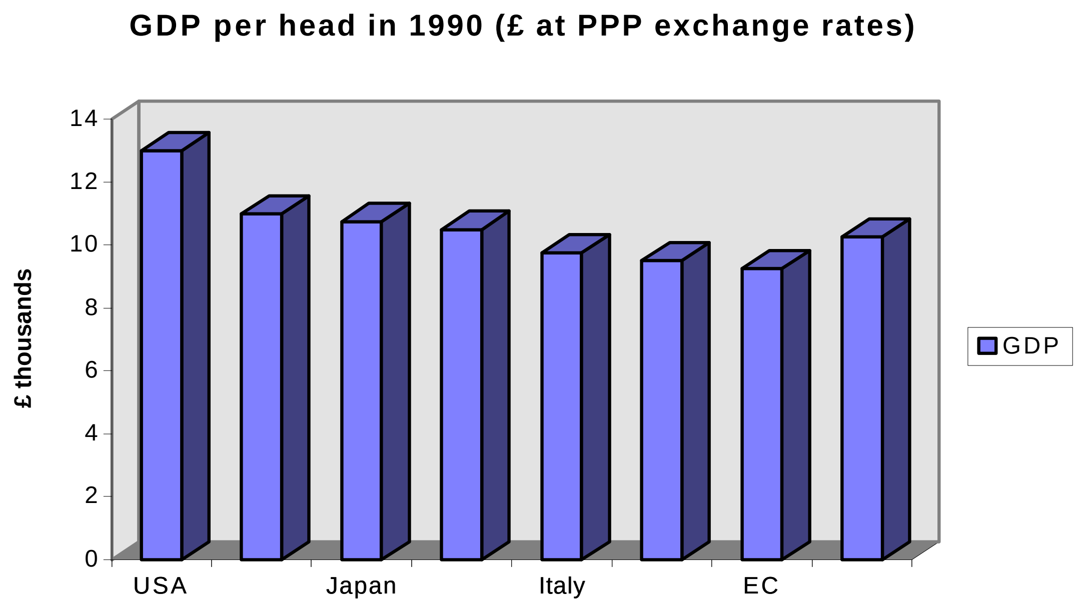


Figure 2 GDP per head, 1990



Unemployment

The UK unemployment experience of recent years compared with other countries shows that the early 1980s policy of economic restructuring resulted in a more painful period in terms of unemployment for the UK, although the statistics show that by 1986 it began to fall quickly. However, once locked into the ERM, the UK unemployment rate rose back above the European Union average. The geographical burden of unemployment has also shifted with recent large job losses in the service sector industries of the South East.

As the problem of unemployment worsened so has the associated levels of long term unemployment (people who are unemployed for a period of more than twelve months). While countries such as Ireland, Spain, Italy, and Belgium have levels of long term unemployment that exceed the UK's; other countries such as Norway and Sweden have successfully devoted resources to avoiding this from occurring. Efforts at controlling long term unemployment in the UK have centred around a tightening of the rules for welfare benefit claimants in order to disqualify those not 'actively seeking work', a reduction in unemployment benefit including a restriction of its duration to six months, and a series of 'back to work' schemes.

A series of measures have been implemented in recent years to tackle the problem of youth unemployment, from on-job Government subsidised training, to financial assistance for young people wishing to start up their own business. Success in this area has been limited and there are fears that there is a growing number of young people who will spend the majority of their adult lives without work and will become unemployable.

Inflation

The painful British experience with inflation during the 1970s led to a general rethink of the approach to Macroeconomic policy. Inflation levels, peaking at 24.2% in 1975 were clearly very damaging to the economy, however, this was not simply a domestic phenomena as fluctuations in the price of crude oil had similar effects across the industrialised world. After 1979, the conquest of inflation became the central plank in the macroeconomic policy of the new Conservative Government. The monetarist experiment of 1979-81 centred on constraining monetary growth and the reduction of the PSBR; while effective at reducing the level of inflation, the resulting high interest rates and strong Pound (Sterling) had the effect of making manufactured exports internationally uncompetitive and led to industrial closures and increased unemployment.

By the mid 1980s inflation in the UK was under control. However, it was also falling in the other ‘G6’ economies, but by 1987 the inflation rate began to rise again as a result of overheating of demand caused by financial liberalisation and relatively low interest rates, peaking at 10% in 1989, undoubtedly related to the housing market. The boom period of the late 1980s had been succeeded by the deepest and longest recession the UK economy has experienced since the war. The 1990s has been characterised by a low inflationary environment - it remains to be seen whether Britain has ‘tackled’ inflation, or whether it remains vulnerable to supply shocks.

Balance of Payments

The long term decline of the UK’s share in manufactured exports meant that by the 1970s the balance of trade was firmly in deficit, although this was offset on the current account by a surplus on invisible trade, particularly the strong performance of Britain’s financial services. Although the visible balance was in surplus during the early 1980s; a time of recession and the restructuring of the manufacturing sector; this was largely to do with revenue raised from North Sea oil coming on-stream. As the economy came out of recession in the mid 1980s the lack of a domestic manufacturing base resulted in the sucking in of imported goods and took the current account into deficit in 1986 despite oil revenue. The UK has a problem with the current account which has temporarily been hidden as a result of the devaluation of Sterling following exit from the ERM in 1992 causing an increase in international competitiveness.

Sterling did not join the ERM until October 1990 and departed in September 1992. Prior to entry to the ERM Sterling’s exchange rate was ‘pegged’, for a period, to the Deutschmark in order to gain stability. Many considered that Sterling entered the ERM at too high a level and it was this, as well as sluggish economic recovery, which signalled to the financial markets the weakness of the UK currency that led to ‘Black Wednesday’ and the UK’s humiliating departure from the ERM.

Supply Side Policies

The concentration on supply side economics was central to the Thatcherite approach, with privatisation of public utilities and beyond emerging as the key policies in this area. The arguments of incentive and competition were used to justify the privatisation umbrella of policies but other objectives of reducing PSBR and weakening public sector Trade Unions, tightening up on work-related benefits, removing the UK's provisions for minimum wages (the Wages Councils) and encouraging non-union foreign direct investment were also clearly evident. Underpinning these objectives was a basic philosophical concept of limiting the scope of government and increasing individual choice. This can be observed in the key policy area of the sale of public sector housing stock to sitting tenants who were given a 'right to buy'. These policies have not been reflected in a falling cyclically-adjusted public sector share of GDP.

Financial Deregulation

Financial deregulation was commenced with the abolition of exchange controls in 1979 and followed in 1980 by the scrapping of the banking 'corset'. Deregulation of the City of London, building societies, personal financial services, and the Stock Exchange (the 'big bang' of 1986) led to a rapid expansion in this sector resulting in it accounting for a 19.8% share of GDP in 1989 (Johnson 1991 *table 4*). Financial deregulation provided the basis for the housing market boom of the late 1980s (Smith 1993) by allowing for an enormous expansion of private mortgage credit. Financial liberalisation in the 1980s put an end to mortgage rationing and opened up the market to other financial institutions. This resulted in Net Mortgage Lending increasing by more than 425% from 1980 to 1988 (Smith 1993).

This short summary of economic trends provides an important set of contextual variables and stylised facts with which to analyse the increasingly connected relationship between the housing sector and the economy. In the next section of the paper, we begin to explore the housing sector context.

3. HOUSING CONTEXT, POLICIES, PATTERNS AND TRENDS

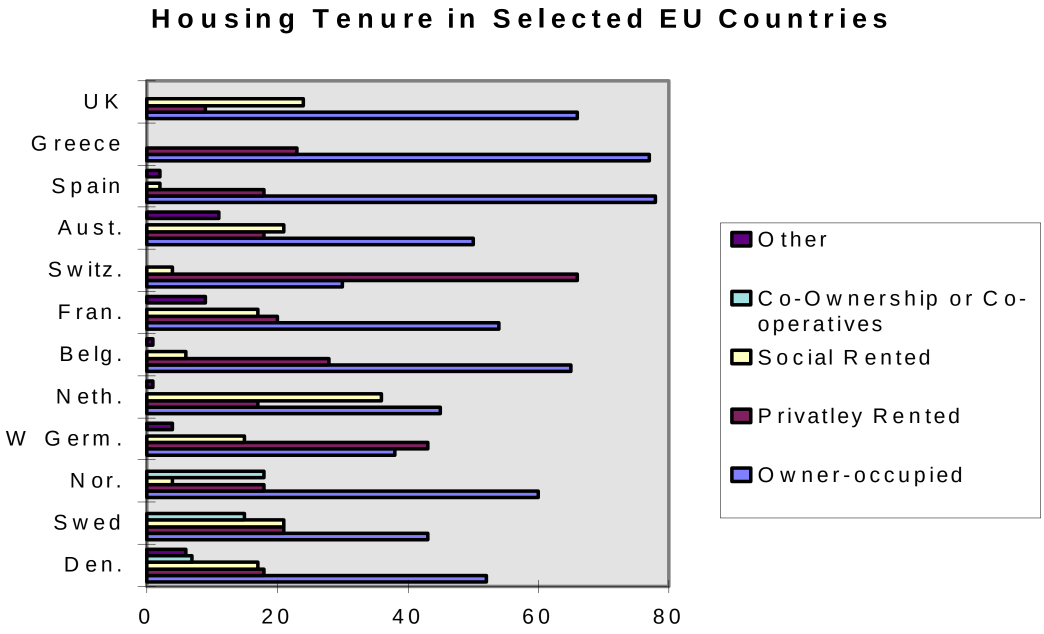
The tenure structure of the housing market in the UK has changed considerably since the turn of the century. The dominance of the private rented sector in the early part of the century, which accounted for 90% of the total stock (McCrone & Stephens 1995), was ended with the boom in the construction of council housing following the end of World War II. In more recent years we have seen a shift towards owner occupation as a tenure choice as well as a growth in the social rented sector. Table 1 shows the strong growth in owner-occupation in the last 14 years, mainly at the expense of council housing. More than two-thirds own their homes and less than one in five now rent from their local authority. Britain is comparatively unusual in that most private housebuilding is speculative. In recent years has become dominated by a relatively small number of large volume speculative house builders who tend to trade in land, hire construction firms to build the houses (which tend to be based in cost-effective but aesthetically limited centralised designs) and then the developer markets and sells the finished homes. The market slump has hit these firms hard, leading to considerable (paper) losses on land transactions, unsold stocks, the collapse of the medium-sized building firm and many strategic casualties among the larger players.

Table 1 Housing Tenure, Great Britain, 1981 and 1994

tenure	**1981**	**1994**
owner	56.4%	66.8%
prs	11%	9.7%
association	2.2%	4%
council	30.3%	19.5%

Source: Wilcox (1995)

Figure 3 Housing Tenure in Selected EU countries



As the European Union has no direct formal responsibility for housing policy, statistical material used for comparing member states may not be compatible and must be treated with caution. Figure 3 (table from McCrone & Stephens, 1995, page18*)* shows that home ownership in the UK is high in comparison with other European nations, especially the richer North European countries. The private rented sector in the UK accounts for the smallest proportion of stock (only 9%) of these comparable nations. Only The Netherlands has a level of non-profit/social rented provision that exceeds the UK's which accounted for 24% of the total stock in 1992.

Household size in the UK has been falling in recent years and projections estimate this trend will continue with a forecast of a 3.5 million increase in the number of households in England in the next two decades (Wilcox 1995). This trend reflects an ageing population, an increase in lone parents and young people who choose to live alone, and also sustained net inward migration. This change in the foundations of household composition clearly has implications for housing needs, however, in the same period that we have seen household size fall we have also seen a reduction in the number of new dwelling completions by an annual average of 29,348 units in the 1990s compared to the 1980s (Wilcox 1995).

A key result of increasing household formation coupled with the decline in the number of new dwellings being built has been the growth in homelessness in the UK. Between 1979 and 1991 the official count of homelessness has more than doubled; with increases of 165% in England, 110% in Wales, and 115% in Scotland (McCrone & Stephens 1995). Housing conditions have been steadily improving in the UK with the number of dwellings lacking basic amenities (bath/shower and/or inside WC) falling from 17.4% in 1970 to just 1% in 1991 (Newton 1994). The private rented sector displays the worst remaining conditions with 20.5% in 1991 being deemed unfit for occupation (Newton 1994).

Housing Policy to 1979

Housing policy from 1945 to the 1970s was dominated by the 'numbers game' (Malpass & Murie 1990) with the emphasis on eliminating housing shortage following the disruption of the war. Whether this objective was best served by expansion of the public or private sectors depended on the political complexion of the government. Rent control was introduced in most of the private rented sector in 1915 largely as a wartime measure however it was difficult to disengage from this policy in peace time and as a result under-investment resulted, in terms of quality and quantity of dwellings for rent (and the greatest single period of disinvestment followed deregulation in 1957).

Following the war 80% of new housing construction was in the public sector up until 1954 when the Government removed the licensing system which had limited private sector development during wartime. Prior to 1954, public sector housing was directed at the better off working class population, this aim was shifted with the encouragement of the private sector to meet general housing needs. The level of investment in public housing stock reflected the Keynesian outlook of macroeconomic policy with counter cyclical 'pump priming' becoming a key feature government concern. The voluntary sector remained small until enabling legislation in 1974. Until then housing associations received little financial support from central government for their activities, having to rely on support from private means, donations and building societies.

Policy since 1979

Already the majority tenure, home ownership by 1979 was transformed, politically, through the dawn of the 'property owning democracy'. For several years, home ownership had been seen as the natural form of tenure for many years with various schemes being designed to encourage owner occupation. Voluntary council house sales were replaced in 1980 by 'The Right to Buy' for all council tenants with two years' tenancy. This policy turned out to be massively successful - selling off 1.5 million homes by the middle of the 1990s. Much of that success must be attributed to the deep discounts available to long-standing tenants. This development has inevitably residualised council housing, however cross party support for home ownership has remained a constant theme for British housing policy.

Capital receipts from the sale of council housing proved to be central to the Governments public expenditure plans, accounting for 43% of all privatisation proceeds from 1980 to 1989 (Forrest & Murie 1994 *in Built to last*), providing a steady stream of capital and allowing scope for a reduction in the PSBR. Sales of council housing are unlikely to sustain at the levels of the 1980s but a further reduction in public sector stock is likely as rent levels rise.

The Housing Act of 1988 introduced the concept of 'tenants choice', prior to this the 1980 Housing Act introduced the 'tenants charter' which clarified and strengthened the legal position of public sector tenants. 'Tenants choice' was a policy development that was aimed at giving people who rented local authority accommodation an option to transfer the control of their property to a different landlord such as a housing association or co-operative. Large Scale Voluntary Transfers (LSVTs) have proved one way of expanding the social rented sector with this form of stock transfer now accounting for 25% of housing association properties. Receipts from the disposal of public stock can be used by the local authority for general expenditure, unlike receipts from right to buy sales, however this policy does result in a further withdrawal of local government from housing provision.

Government control of the private rented sector has a long history in the UK. Introduced as a response to perceived exploitation by individual landlords rent control is blamed by the present Government for the long term decline in this sector. Attempts at de-control have been made in the past, however, it was not until 1988 that new tenancy arrangements were introduced so that; “landlords could either let on an assured tenancy basis, with rents freely negotiated between the landlord and tenant, or let on a shorthold or short tenancy basis, with no security beyond the period of the tenancy but with the right of either party to seek registration of an appropriate rent.” (Malpass & Murie 1990).

At the same time, the Government amended a tax incentive vehicle hitherto used to encourage tax-free investment in risky enterprises, to encourage five year investment in deregulated private renting. The Business Expansion Scheme (BES) produced more than 80,000 units of new investment but the subsidy rate, around 50-60% per unit for a five year shelf life was attractive to tax avoidance industries and not to commercial letting. Additionally, the property slump has since made it difficult for several of the companies to exit the market at the end of the five year qualifying period. In legislation presently underway, the Government plans to create a new investment trust that will provide tax transparency in order to encourage institutional investors to take a stake in private rented housing. It remains uncertain whether the yield gap between actual and required rates of return has been closed by such a device.

Seen as the ‘third arm’ of housing policy (Malpass & Murie 1990) housing associations provide a choice for people unwilling or unable to enter the two main tenure choices. After the expansion of the Housing Corporation (the English national housing agency) in 1974 housing associations received a boost. However, since 1979 this sector has enjoyed increasing favour with central Government as it provides a decentralised alternative to local authority controlled housing. Associations are encouraged to seek funding from the private sector to supplement the Housing Association Grant (HAG) that is provided by the Housing Corporation, in order to finance capital investment. Recent concern over public expenditure has led to pressure being put on HAG levels which has affordability implications for housing association properties, resulting in a knock on effect for public expenditure through the social security system as tenants claim state benefit to subsidise their rent. After a period where associations were feted by Whitehall, they now face severe budgetary pressures with both the overall development programme and the proportion of individual projects met by public grant cut back.

Coinciding with the residualisation and reduction of the public sector housing stock in the UK has been the experience in increasing levels of homelessness. Between 1983 and 1989 the numbers of households, accepted as homeless by local authorities in the UK, increased by 61% (Gibb & Munro 1991). Increasing levels of street homelessness and families being housed in temporary accommodation in the 1980s heightened public concern over this issue. Central Government believed that the problem of homelessness could be attributed to mismanagement of public housing stock by local authorities and pointed to high rates of void housing in the public sector as evidence. By 1989 the Government provided an extra £250 million over two years to combat homelessness (Malpass & Murie 1990). In 1995, the Government proposed, withdrew and then re-formulated legislation to reform policies in this area - these have been roundly attacked by the housing lobby for pushing statutory homeless households into temporary private accommodation and for taking moral judgements on who should be prioritised.

The current system of social security payments to help low income households with their housing costs, housing benefit, was introduced in 1982 with a major reform in 1988 and various alterations to the detail of policy in order to reduce the scope and escalating costs of the scheme. Housing benefit provides a means tested support for households in financial need in many cases accounting for a 100% subsidy, unique amongst European Union members. Once household income rises above a pre-defined threshold a 65% taper in the rate of benefit eligible is enforced which has implications for individuals' employment choices and incentives. The fact that recipients of housing benefit are insulated from marginal increases in rent levels means that there is an incentive for households to over consume in housing terms, in other words claimants are not encouraged to economise. The deregulation of the private rented market and encouragement of local authorities to set market rents has resulted in spiralling costs in the housing benefit system with a doubling of real expenditure on housing benefit in Great Britain since 1983 (Newton 1994).

The state also supports owner occupiers who become unemployed and have low savings, in the form of income support for mortgage interest (ISMI) which has been in existence since 1948. The Government is attempting to withdraw from this commitment by reforming the present system of payments by delaying payment for the first nine month period of a claim for a new loan, and encouraging people instead to take out private insurance. People on the margins of home ownership are unlikely to be able to afford the further expense of private insurance and as a result repossession of property due to default is likely to rise. Furthermore there are formidable technical problems of moral hazard and adverse selection associated with this sort of policy making it very unlikely to be either efficient or comprehensive (Gibb, 1995).

A useful way to summarise a lot of these subsidy and finance issues, especially for the reader unfamiliar to Britain's housing would be to briefly set down the subsidy arrangements pertaining to each tenure. Below is set out the key capital and revenue forms of support faced by households in each part of the British housing system.

<u>Owner Occupiers</u> receive a major subsidy if they enter the tenure via the Right To Buy their council home - this is typically 50% of the capital value but can be 70% for flats. The main subsidies, however, are tax expenditures in the form of mortgage interest deductibility. In Britain this is taken at source (called MIRAS) and works by assuming a mortgage ceiling of £30,000 (less than half the mean house price). A fixed deduction of 15% of interest payments up to that ceiling is made. In the 1990s, the percentage subsidy has fallen from the household's marginal tax rate, to the basic rate, to 20% and then to 15%. Owners do not pay capital gains tax on sale of property, nor do they pay an imputed income tax (abolished in 1963). There is only a very minor transactions tax (stamp duty which is 1% of properties above £60,000). Britain also has a banded property tax, the council tax, which has deductions for single adults and has no provision for a general revaluation. This tax is very flat - properties in the top band by value pay only three times what properties in the cheapest band pay, even though they are valued at eight times the cheapest banding. Overall, therefore, the system is characterised by low taxation and little explicit subsidy. This is all the more accurate with the recent restrictions placed on low income support with mortgage interest payments through the social security system.

Private renting is treated as a business for taxation purposes - facing income tax and capital gain taxes, after legitimate expenses; and there are no ceilings on the deductibility of loans. Property in Britain is not eligible for depreciation allowances. The only other element of relevance is the imminent creation of a tax concessionary housing investment trust which will make institutional investment more tax efficient.

Council renting creates below market rents in a complex way. Each authority has a dedicated well-defined housing revenue account which must not earn a deficit. Expenditure items include debt charges, repair, maintenance and management costs. The main income items are rents and government subsidy. Government exercises considerable control over these HRAs in order to control rent levels. Any surplus in English authorities is used to reduce the cost of housing benefit to that authority's tenants. At the moment, rental surpluses pay for around 1/4 of all local authority housing benefit costs. This system does not apply in Scotland.

The HRA system determines average rents in each authority's housing stock. The distribution of rents within an authority's stock is determined by the locally-determined rent policy - these are historically rather flat based on bureaucratic policies, varying rents according to property size, type and local amenity - there is no necessary link with value. The evidence from Right to Buy sales concurs that this flatness can create severe anomalies in valuation and in the cost of rented property.

Housing associations receive large up-front capital grants with average rents based on the cost of servicing the residual private loan plus elements for management, maintenance and depreciation. Rents are still below market levels and rent structures are base don ill-defined principles of 'affordability'. This usually is thought to mean what a low income working household could afford. In Scotland, for instance, the housing association movement reckons that either no more than 25% of net income should go on rent or that after rents, a household should have at least 140% of the relevant income threshold as set out by the British system of social security (income support).

With this broad housing and economic background in place it is now possible to move on and look at the core question of this paper - how has the housing sector come to play such a critical role in the wider economy's fortunes?

4. HOUSING AND THE ECONOMY

Building societies emerged as mutual self help organisations early in the 19th century facilitating advances on investment in private building. The growth of home ownership during this century has been matched by the growth of assets and influence of the building society movement which gains added power by organising cartel arrangements in the mortgage market under the Building Societies Association (BSA). This arrangement survived until 1983. The lack of price competition allied with the non profit maximising nature of the societies and the financial regime they operated under led to demand for mortgages to far exceed the funds available for lending with the result being a quantity-based rationing system, with a waiting period that could typically be up to two years. First time buyers in the owner occupation market were treated with caution and limits on the amount they could borrow were enforced by building societies in a lending environment that could be described as circumspect. The typical mortgage product was a standard variable rate repayment mortgage (annuity mortgage) which would be 20 to 25 years in length with interest payments tax deductible at the marginal rate of tax (later significantly reduced in the 1990s). Table two describes the lending patterns of British mortgage lending since 1980 and table three shows a summary of society progress since 1920.

Table 2 Loans for House purchase by lender (£m) 1980-93 (net advances)

year	building societies	local authority	insur. and pension funds	banks	other specialist lenders	other public sector	total
1980	5722	456	263	500		341	7368
1981	6331	271	88	2265		353	9483
1982	8147	555	6	5078		356	14128
1983	10928	-306	126	3531		40	14525
1984	14572	-195	250	2043		-42	17069
1985	14711	-502	201	4223		60	19118
1986	19548	-506	511	5197		54	27183
1987	15076	-433	825	10104	3952	49	29573
1988	23720	-329	447	10894	5234	144	40111
1989	24002	-230	30	7169	2952	134	34054
1990	24140	-322	124	6411	2916	-103	33164
1991	24140	-446	-233	4803	2172	-438	26785
1992	20927	-359	-96	6577	-1396	-107	18488
1993[1]	7265	-187	-261	7231	-2113	-58	11877

Source: CML, 1994, table 3.
Note 1.: first three quarters.

Table 3 Building Societies 1910-1992

year	no. of societies	shareholders (000s)	depositors (000s)	borrowers (000s)	mortgage balances (£m)	total assets (£m)	advances in year (000s)
1910	1723	626			60	76	
1920	1271	748			69	87	
1930	1026	1449	428	720	316	371	159
1940	952	2088	771	1503	678	756	43
1950	819	2256	654	1508	1060	1256	302
1960	726	3910	571	2349	2647	3166	387
1970	481	10265	618	3655	8752	10819	624
1980	273	30636	915	5383	42437	53793	936
1990	117	36948	4299	6998	175745	216848	1397
1992	105	37533	3879	7055	210995	262515	1187

Source: CML, 1994, table 24
Note: figures for 1990 and 1992 include Northern Ireland and exclude Abbey National and the number of advances include further advances.

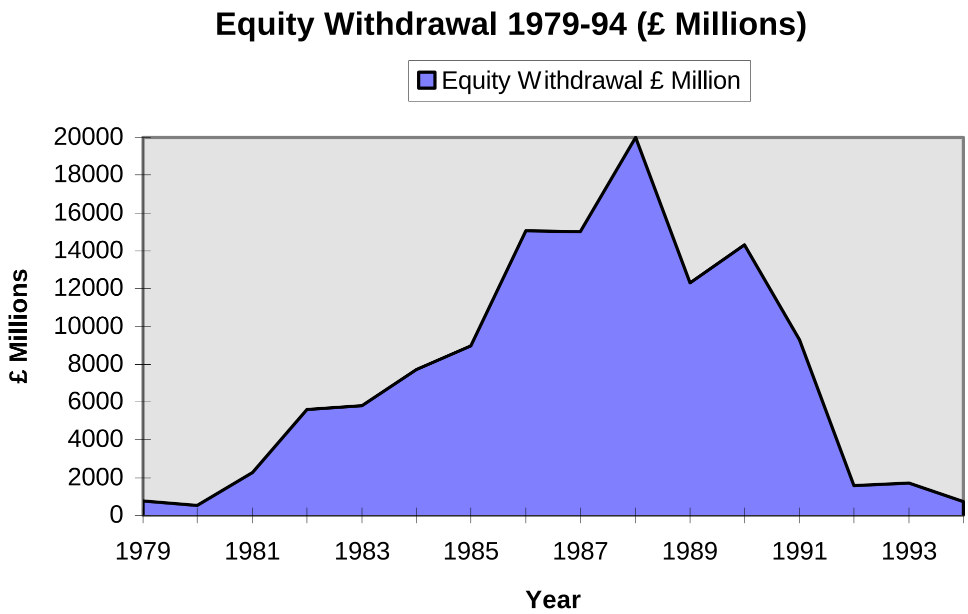
The system of mortgage rationing was clearly a hindrance for further rapid expansion of home ownership in the UK so when exchange controls were dropped (1979) and the 'corset' restriction on bank lending was abolished (1980) the way was left open for the entry of the banking sector into the mortgage market (they took 40% of the share of new loans in their first year post-entry). The increase in competition in the home loans market quickly exposed tension in the BSA cartel and by 1983 a major Society (the Abbey National) further weakened the cartel by threatening withdrawal and leading to the BSA to act purely in an advisory role in interest rate setting. Effectively, interest rates were now set by wider market forces. By 1986 the Building Societies Act enabled the larger societies to operate many of the same services as banks and this legislation allowed scope for building societies to engage in second mortgage activity and also to lend a proportion of their assets (5%) in the form of unsecured loans in direct competition with the major clearing banks. The share of 'risky' assets has subsequently been increased to 20%. Societies could now borrow 40% of their funds for new lending from the banking sector (now 50%) - see table 4. This and the full entry into the market by the banks effectively ended quantity rationing of mortgages. Not only were products competitively priced, the range of mortgage products exploded, confronting the consumer with literally hundreds of different mortgages (endowments, pension-linked, unit trust-linked, discounted, fixed rate, etc.). Retail banking operations are now available to the customers of building societies, with current accounts, cheque books, and credit cards available. This blurring of the distinction between the operations of banks and building societies has led to one society becoming a limited company and so losing its mutual status. At present there is a rush to merge and convey existing societies into banks as institutions struggle to come to terms with the new, more competitive environment.

Table 4 Building Societies Net deposits and Wholesale Funding, 1981-93, £m

year	net receipts[1]	net wholesale funding
1981	3601	102
1982	6466	252
1983	6839	1635
1984	8572	2228
1985	7462	3093
1986	6592	6141
1987	7487	3150
1988	13554	5466
1989	7738	8226
1990	6562	9221
1991	5804	6527
1992	295	3878
1993	2200	2869

Source: CML, 1994, table 23.

Figure 4: Equity Withdrawal



The end of credit rationing led to a flurry of activity in the housing market as households saw the opportunity to take out second mortgages to take advantage of the wealth effects they experienced due rapidly rising nominal house prices in the late 1980s. This phenomenon of equity withdrawal fuelled the consumption-led boom (1986-88) by increasing non-housing spending resulting in inflationary consumption and increasing levels of imported goods. In 1988 the housing equity withdrawn for non-housing spending exceed £20 billion or 6% of total personal sector consumption (see figure 4). Miles (1992) estimates that the marginal propensity to consume out of equity withdrawal is somewhere between 0.5 and 0.75 and could even be as high as 0.78. (see, Maclennan & Gibb, 1993).

'Boom to Bust'

There have been three major house price cycles in the last 25 years in the UK, the last cycle reaching its peak in 1988 with 1.99 million housing transactions (Maclennan 1994) - see table 5 and figure 5. The favourable way that owner occupation is treated in the UK is reflected in the tax regime that operates (see above). It was the above mentioned favourable tax treatment of owner occupation that was a central element in the ‘Lawson’ boom that led to high levels of housing speculation and greatly increased nominal house prices in the late 1980s, throughout the nation, but especially in the overcrowded South East and London markets.

Figure 5: House Prices and Inflation

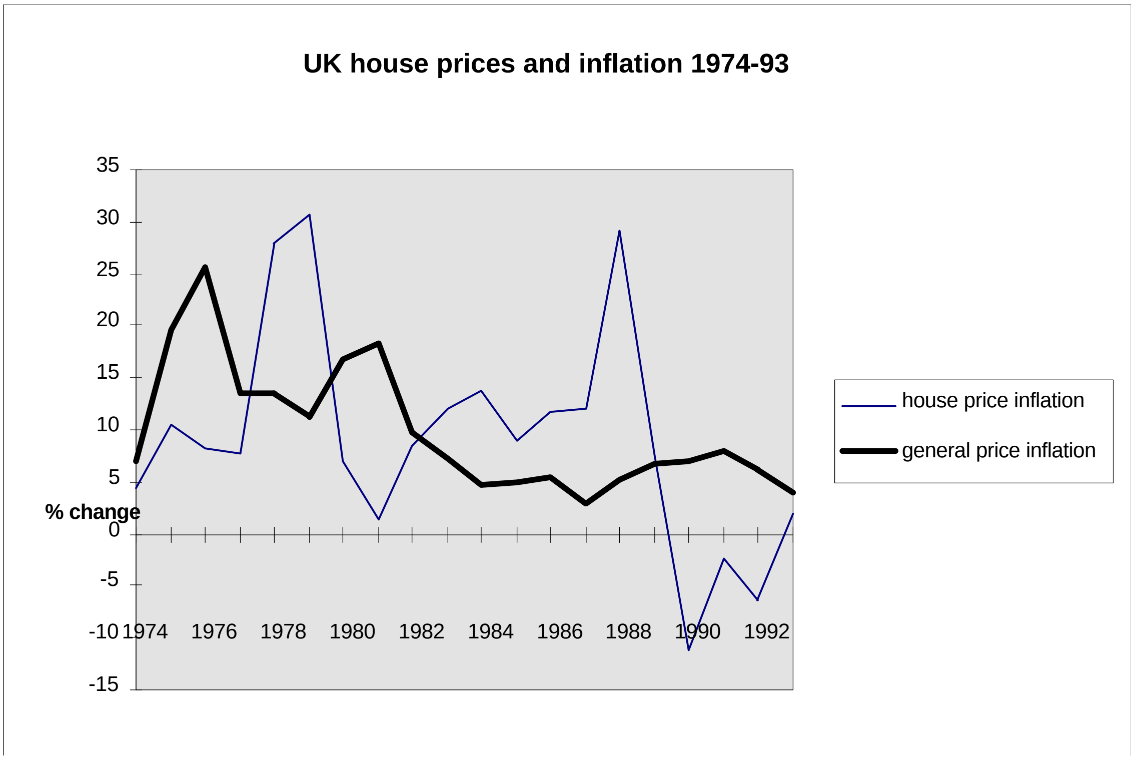


Table 5 UK House Prices 1981-93 and inflation

year	average price[1]	% change in average price of housing	GDP deflator (% change)
1981	24503	4.2	9.67
1982	24577	0.3	7.12
1983	27192	10.6	4.64
1984	29648	9.0	5.02
1985	31876	7.5	5.55
1986	36869	15.7	2.93
1987	42546	15.4	5.33
1988	52632	23.7	6.71
1989	58971	12.0	6.95
1990	64657	9.6	8.06
1991	66459	2.8	6.33
1992	64061	-3.6	3.86
1993	65555	2.3	3.25

Source: CML, 1994, table 16

Note: all houses at mortgage completion stage from BSA/DoE 5% survey.

The UK economy during this period (1988) was beginning to exhibit signs of overheating with inflation levels being pushed up by frenzied housing market activity. The response of the Chancellor of the Exchequer was to raise interest rates in order to slow down the economy and reduce the level of inflation. We saw that the majority of home owners in the UK have variable rate mortgages and as such an increase in interest rates will have a direct effect on their levels of disposable income. Interest rates increased from 7.5% in 1987 to 15% in 1989, which, as well as the effect this has on home owners also had a devastating effect on the construction industry, with an estimated 500,000 construction workers becoming unemployed between 1988 and 1993 (Maclennan 1994).

Table 6 Mortgage Arrears and Possessions, 1981-93, United Kingdom

year	stock of loans at year-end (000s)	re-posse-ssions (no.)	re-posse-ssions (%)	6-12 months in arrears (no.)	6-12 months in arrears (%)	12 plus months in arrears (no.)	12 plus months in arrears (%)
1981	6336	4870	0.08	21540	0.34		
1982	6518	6860	0.11	27380	0.42	5540	0.08
1983	6846	8420	0.12	29440	0.43	7530	0.11
1984	7313	12400	0.17	48270	0.66	9510	0.13
1985	7717	19300	0.25	57110	0.74	13120	0.17
1986	8138	24090	0.3	52080	0.64	13020	0.16
1987	8283	26390	0.32	55490	0.67	14960	0.18
1988	8564	18510	0.22	42810	0.5	10280	0.12
1989	9125	15810	0.17	66800	0.73	13840	0.15
1990	9415	43890	0.47	123110	1.31	36100	0.38
1991	9815	75540	0.77	183610	1.87	91740	0.93
1992	9922	68540	0.69	205010	2.07	147040	1.48
1993	10137	58540	0.58	164620	1.62	151810	1.5

Source: CML, 1994 Table 11

Unlike the previous two house price cycles the overshooting in the market of the late 1980s was followed by a reduction in nominal (not just real) house prices. This had implications for public confidence in the housing market at a time when mortgage arrears and repossessions were rising rapidly due to increasing unemployment, the changing nature of the labour market, and the overexposure of marginal households in the housing market who were encouraged into owner occupation by the advantages offered and the lack of alternative tenure choices. The experience of negative equity (house prices' current values lower than outstanding mortgage debt) also severely damaged the housing market especially in the South East where the house price boom and mortgage gearing was most pronounced. By the end of 1983 1.5 million households, a quarter of all households who had purchased homes between 1988-1991 (Maclennan 1994), were affected, severely inhibiting people's willingness to move and thereby deepening the crisis in the turnover-based housing market. More than 300,000 homes have been repossessed since 1989 and presently more than 250,000 are in arrears (table 6).

Housing market instability

The Duke of Edinburgh's Second Inquiry into British Housing (1991) highlighted inadequate investment in rented accommodation and financial bias towards owner occupation as the major causes of difficulty in the market. The UK has the highest proportion of owner occupiers under the age of 30 of any industrialised Western country meaning that limited time is given for households to accrue wealth before entering the home buying market. Not only is there lack of choice in the private rented sector, but it is in this area that housing conditions appear to be of relatively poor quality. On the demand-side, therefore, there is an inherent inelasticity of demand because of the lack of alternatives to buying and gearing up debt. The relative sensitivity of housing supply to price changes appears to be very inelastic - the UK appears to suffer a particular problem in this respect with a intricate planning system and a speculative property development sector. This inelasticity of supply serves to magnify price shocks to the housing market as it enables a disequilibrium position to be maintained even in the medium term.

The changing world of international trade has led European countries to reassess their economic policy in response to the emerging 'Pacific rim' economies. Within this reassessment the UK government in the 1980s became the leading exponent of flexible labour market policies within the EU (Maclennan 1994). At the same time as pursuing this policy objective a counter cyclical monetary policy was used to combat inflation. This low inflation/high labour flexibility (including geographical mobility) philosophy appears to be incompatible with the strong encouragement for home ownership that has been implemented in the same period.

The relationship between the housing market and the economy as a whole is clearly fundamental to the economic well-being of the nation and is unquestionably a two way process. Housing constitutes an important part of households expenditure over a considerable length of time and so affects savings and consumption patterns to a greater extent than any other single item. The relationship with the labour market is one that is having to adapt to changing international circumstances, however, this would logically seem to point to developing more flexibility in the housing market in the form of easy access rented accommodation rather then households being encouraged to make the long term commitment of owner occupation.

Recent experience of the housing market slump has strengthened calls for a fundamental reshaping of policy to ensure that the boom/bust cycle will not be as marked in the future. The international importance of the UK experience of financial deregulation is clear in that the expansion of available mortgage credit alone will not enable households to have a real choice in terms of suitable tenure. This highlights the need to develop a more neutral housing policy in order to build in greater flexibility and allow the market to operate more efficiently. The fight against rising levels of public spending continues, this can be seen with the escalating costs of housing benefit despite various attempts to limit the scope of payments. Households forced out of owning either by repossession or through unemployment during the recession have swelled the housing benefit budget especially as market rents have been encouraged in the social rented sector and the levels of deregulation that have been implemented in the private rented sector.

5. CONCLUSIONS

This short discussion paper has raised some of the key features of the way the housing system and economy interact. To do this it has been necessary to provide the reader, unfamiliar with British housing, with a considerable amount of contextual detail. A number of important conclusions stand out.

- Financial deregulation of mortgage finance has had a large impact on the personal sector and the housing market. Arguably, it has increased the liquidity of personal wealth and made an unstable housing market more volatile. At the same time, lending is more elastic, there is greater choice of mortgage product, increased competition but also greater risk for lenders, insurers and borrowers.

- British housing policy has long been dominated by the single objective of maximising home ownership (the mirror of dismantling council housing). While this remains true, it appears that in 1996 the chief housing policy is in fact to reduce public spending (and tax breaks) wherever possible.
- The lengthy housing market recession has left the British housing market with a much lower level of transactions and flat house prices, despite significant regional variations. This has had a damaging effect on the economy at a number of levels - it has reduced mortgage lending business (25% of which is now re-mortgaging of existing deals), it has damaged the professionals who deal in house buying and selling (lawyers, estate agents, surveyors), it has damaged the construction industry and it has affected those markets involved in improvements, removals, building work, etc. These have multiplier effects which widen the impact of the ripples from lower levels of housing market activity.
- One major consequence of the housing market's problems has been a realignment in the insurance industry. It was the general insurers who were hit hardest by repossessions and defaults because they insured lenders against lost value. The nature of the policies allowed a moral hazard wherein lenders could afford to lend liberally. This is no longer true and now lenders bear a significant portion of the risk.
- At the same time, government is trying to reduce the social security cost of low income home owners mortgage repayments. This is to be achieved by private mortgage protection insurance - a system bedevilled with technical inefficiencies (Gibb, 1995).
- The big question for the future is whether this extended period of disequilibrium will continue? Does it simply reflect cyclical forces which will eventually unwind, or, is something permanent and structural going on? Many commentators argue that housing is no longer perceived as a speculative asset but primarily as consumption, as a 'home'. Other, less optimistic, commentators suggest that this is myopic and a longer view will see housing market speculation resurrected when the appropriate conditions prevail. In other words, policy measures to stabilise housing and to redress the balance of advantage remain. This is a view with which the authors would concur.

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