

Investment in housing and its contribution to economic growth

Report prepared for Shelter

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1 Introduction

1.1 FTI Consulting has been engaged by Shelter to evaluate and assess the case for investing in housing as part of a government strategy to promote economic growth. Shelter thanks Legal & General for its continued support on housing economics.

1.1 The principal argument to be explored is whether and to what extent investment in housing could help promote growth in the short run while also helping to raise the underlying growth rate over time.

Overview

1.2 The current uncertainty over growth prospects worldwide means that the case for a short term stimulus to the UK economy has increased since the 2011 Budget. The Bank of England has resumed quantitative easing but that may not be enough. There may in addition be a need to relax fiscal policy by a combination of increased spending and reduced taxes. Action to increase investment in housing has attractive properties in terms of increasing growth quickly: there is spare capacity in the industry and sufficient land available for extra investment to quickly turn into increased activity; in addition, relatively little of the extra demands leaks outside the UK. Increased investment also has the benefit of improving the UK's long term growth potential because of its beneficial impact on overall economic capacity and through strengthening labour mobility and work incentives.

Content of this report

1.3 The remainder of this report is set out as follows:

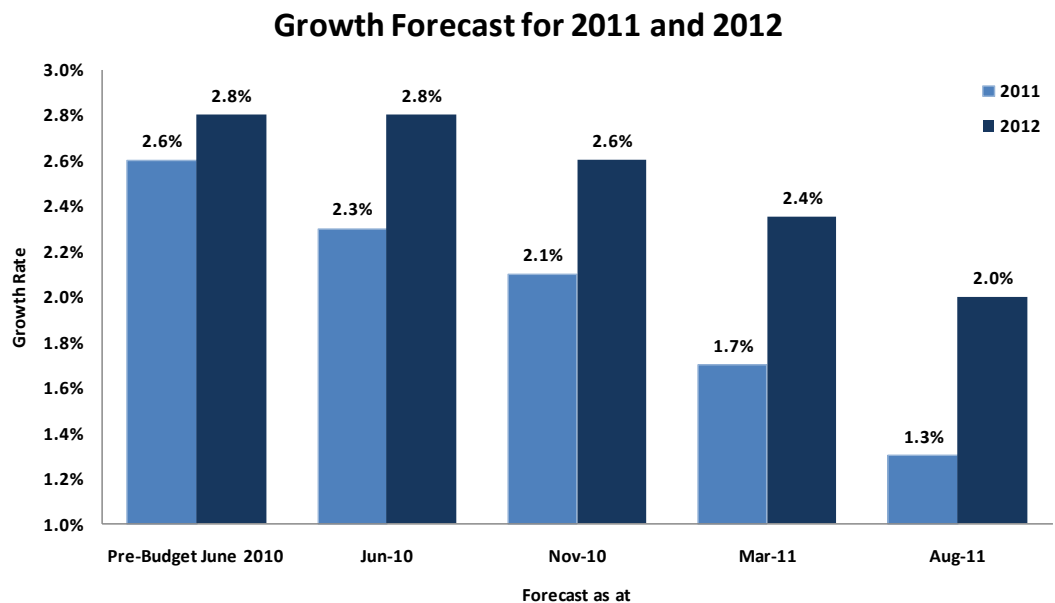
- In Section 2 we examine the argument for a fiscal stimulus;
- In Section 3 we consider the macro properties of investment in housing;
- In Section 4 we discuss the pros and cons of investment in housing versus alternative approaches;
- In Section 5 we look at the longer term impact of housing investment on growth; and
- In Section 6 we briefly discuss the different methods for delivering additional investment in housing and their delivery of both short term and long term economic benefits.

2 Scene setting: the case for a stimulus package

2.1 Expectations of the strength of economic recovery in the UK and worldwide have become less optimistic in recent months. There are continued fears of a financial crisis arising from sovereign debt exposure within the EuroZone. The recovery in the USA has weakened. China and India have taken steps to moderate demand growth because of inflationary pressures.

2.2 Figure 1 shows how the latest forecasts for 2011 and 2012 differ from those made since the election. Slower growth will have real and financial consequences. Unemployment is likely to be higher, income levels to be lower, and debt levels a lot larger than was previously predicted, so progress in reducing the deficit might not proceed as planned.

Figure 1



Source: Pre-budget forecast June 2011, Budget forecast June 2010, Economics and Fiscal Outlook, November 2010 and March 2011 all OBR; August 2011 is average of independent forecasts from Forecast of the Economy, HM Treasury.

2.3 The government will have to decide what to do if this continues. It has so far been very keen to emphasise that it is sticking to the plans it announced back in June 2010, which called for the cyclically-adjusted current account to be in balance by



2015-16. This, it argues, has helped the UK remain a 'safe haven' and has kept interest rates down.

- 2.4 However there may be increasing interest within government in additional measures to stimulate the economy. This is both for political and economic reasons. In particular consumer and business confidence is now pretty low¹. The government may feel that it needs to take steps to boost the economy both through measures that provide a net stimulus and through confidence raising measures that affect perceptions – and hence behaviour. The Autumn Statement on 29 November will contain the latest instalment of government measures to promote growth, but these have so far tended to be measures that will increase the growth potential of the economy in the medium to long term. The question is whether there will be additional measures to provide a short term stimulus.
- 2.5 The range of options open to government is limited. The Bank of England has resumed Quantitative Easing (QE) with a further £75 billion to be used for the purchase of assets. This may stimulate credit but it does depend on how the additional liquidity is used by the banks and on there being sufficient demand for credit – which might not be the case if confidence is already low. Most of the discussions of likely measures to be announced in the Autumn Statement centres on tax breaks of one sort or another, but there are a number of other options. The issue for the government is how they might impact on its deficit reduction targets.
- 2.6 The government will naturally be wary of the reaction of financial markets to any move away from pre-announced plans. On the other hand many commentators and even the Head of the IMF² have been pointing out that markets are becoming just as – if not more - concerned with slow growth as they are with fiscal retrenchment. In addition there is an argument that to announce a loosening of fiscal policy now, coupled with some tightening of policy in the medium term, is something the markets would take in their stride as long as it was seen as credible.

¹ For example, the latest British Chambers of Commerce Economic Survey for Q3 2011 showed falling levels of business optimism with expectations for the volume of home orders turning negative in both manufacturing and service sectors, i.e. firms in both sectors expect demand to fall.

² <http://www.ft.com/cms/s/0/315ed340-c72b-11e0-a9ef-0014feabdc0.html>



- 2.7 Investment in infrastructure provides a good way to stimulate the economy³ since investment in assets that underpin economic activity gives positive returns to the country. Hence the spending increases the ability of the UK to repay the debt in future. This should worry financial markets less than [current] spending that has no such effect on future growth potential.
- 2.8 For a variety of reasons that we go on to discuss, one of the leading options for infrastructure investment is housing. Additional investment could take place through direct government investment or via policies to increase the effective demand for housing⁴.

³ The Case for Global Fiscal Stimulus, Charles Freedman, Michael Kumhof, Douglas Laxton, and Jaewoo Lee, IMF 2009

⁴ We use the term “effective demand” to indicate demand that is supported by an ability to pay. There may, of course, be additional individuals and families in need of housing who are unable to pay the market rent or price

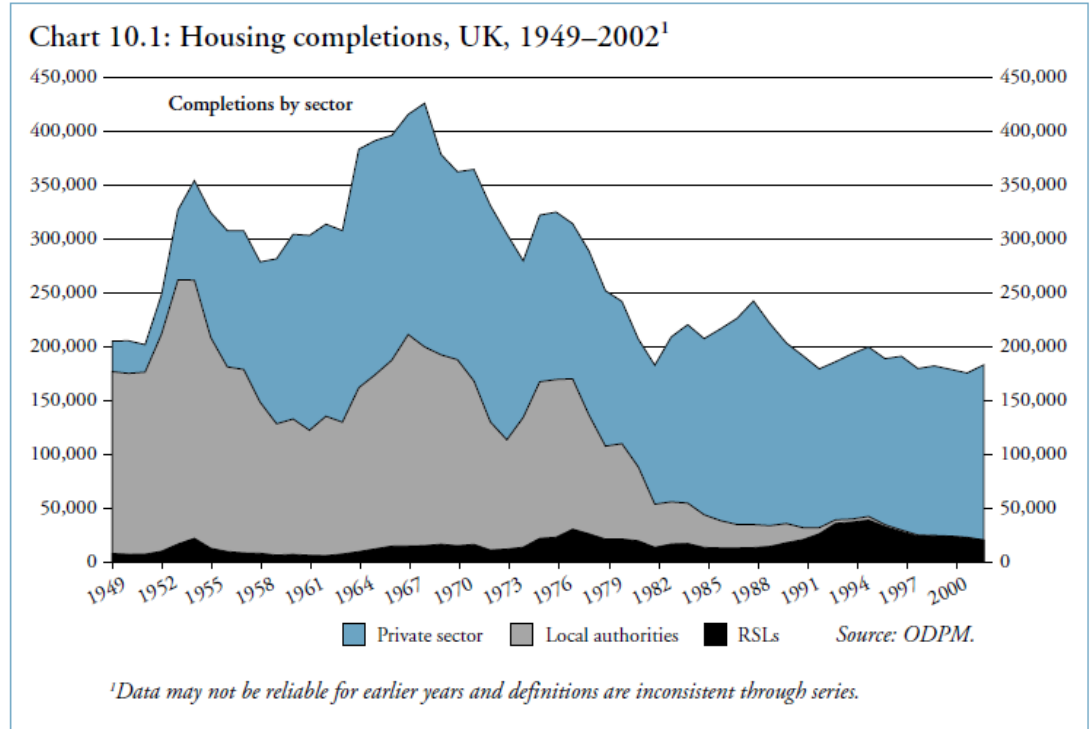


3 The case for investment in house building as a macro stimulus

- 3.1 Investment in house building creates jobs for construction workers and those in associated occupations which have knock-on effects on demand. However, we need to be clear first of all that an expansion of house building is possible and that it would not add to inflationary pressures in the economy.
- 3.2 House building tends to be very cyclical. Indeed construction is usually one of the first sectors into recession and one of the first to come out. Figure 2 (produced for the Barker Report⁵) looks at the record since the war and shows that the trend has been dominated by the collapse in council house building from the late 1970s in particular. But it also shows the fall in private sector completions in recessions with increases in boom times.

⁵ Barker Review of Housing Supply Interim Report, Chapter 10, December 2003. http://www.hm-treasury.gov.uk/media/5/F/barkerreview_interim_chapters7to10.pdf

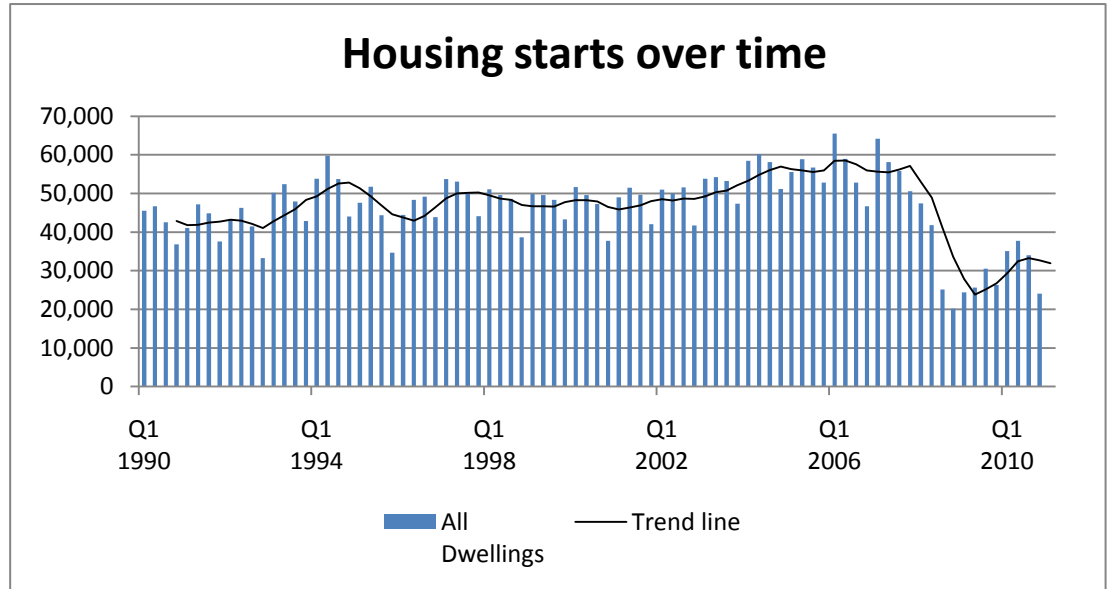
Figure 2



Source: Barker Review

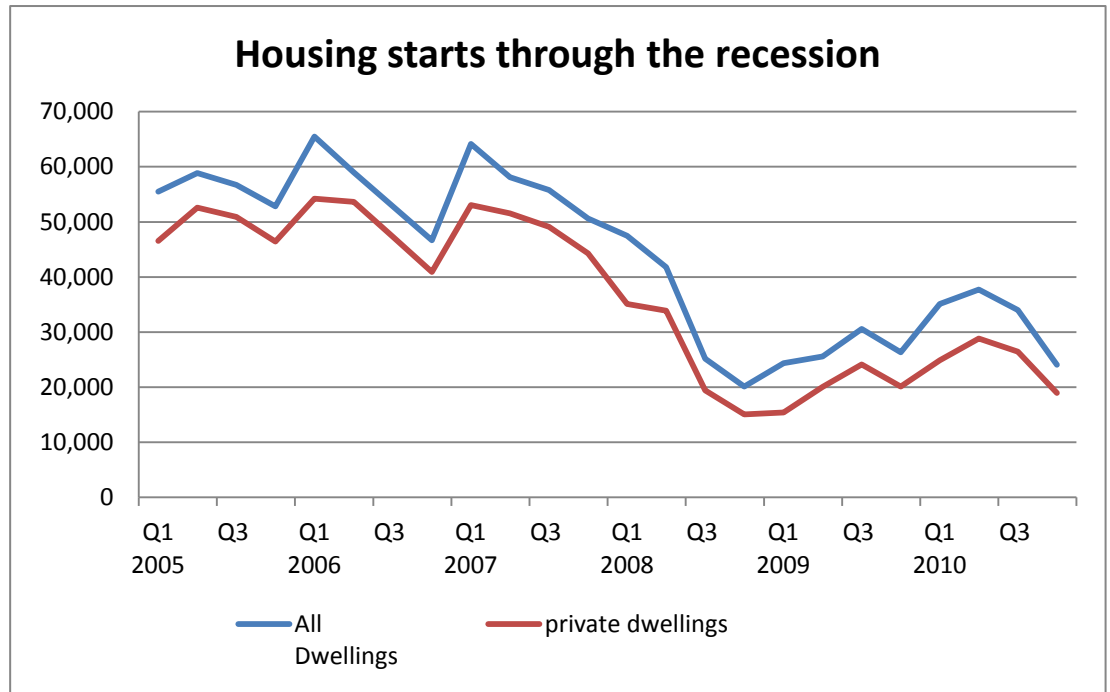
- 3.3 Examining data on housing starts over the last 20 years shows this trend more clearly, as shown in Figure 3. While starts were low in the 1990-1992 recession, they fell by much more in the latest 2008-2010 recession.

Figure 3



Source: DCLG 'live tables' Table 211

- 3.4 Figure 4 shows just how bad things have got since the financial crash. Starts fell sharply through 2007 and 2008 although government counter cyclical measures (including on housing) meant there was some recovery from 2009 through mid 2010 before another sharp fall coinciding with the fiscal tightening programme of the Coalition government.

Figure 4


Source: DCLG 'live tables' Table 211

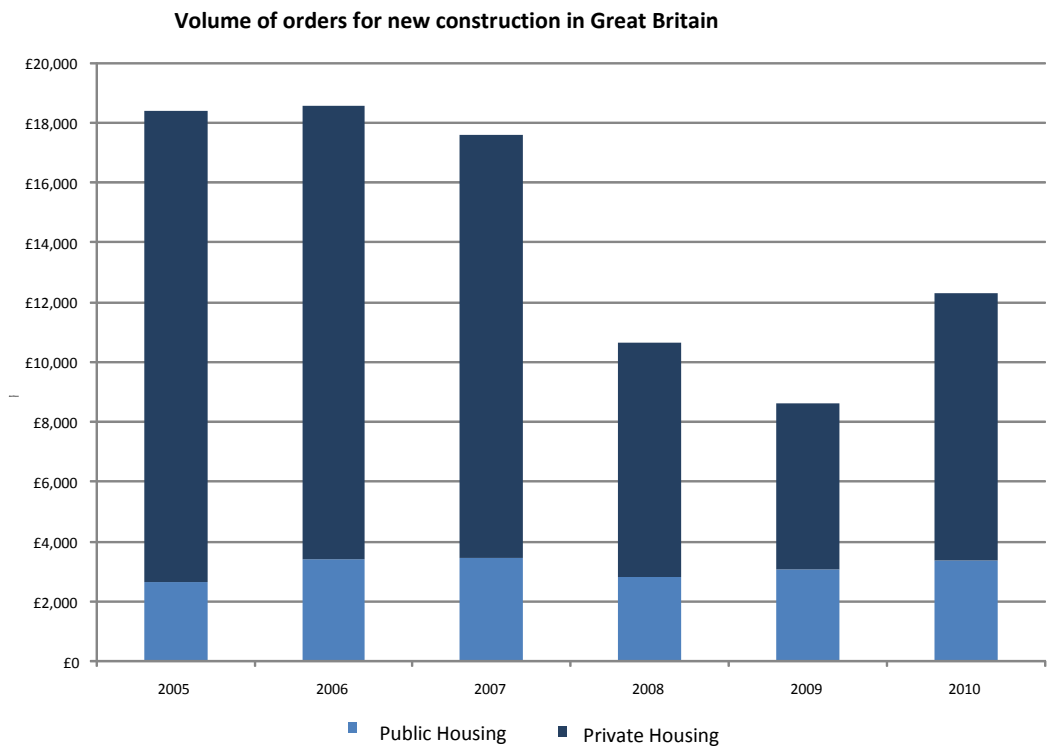
Spare capacity

- 3.5 The data above suggest that new housing construction is well below levels seen in non-recessionary times. This is important. If it is clear that there is spare capacity in the sector at present, investment here would not put any upward pressure on inflation or use up resources needed elsewhere in the economy. It also suggests that effective demand for new housing is the constraint, at least at the moment, so policies to increase demand should bring forward a supply response. Other data support this.
- 3.6 Since 2008 the contraction of construction activity has been marked and has been more severe than for the overall economy. Between 2008 Q1 and 2009 Q4 construction sector output declined by 13% compared to 6% across all sectors. It

recovered somewhat in 2010 so that by 2011 Q1 it was 8% lower than in 2008 Q1 as opposed to the whole economy fall of 4%⁶.

3.7 While the value of housing orders has declined in both public and private sectors, the decline in private sector demand was at first much sharper. Public housing orders increased from 20% of total orders in 2007 to 36% in 2009 with a fall back to 27% in 2010⁷. This is shown in Figure 5 below.

Figure 5



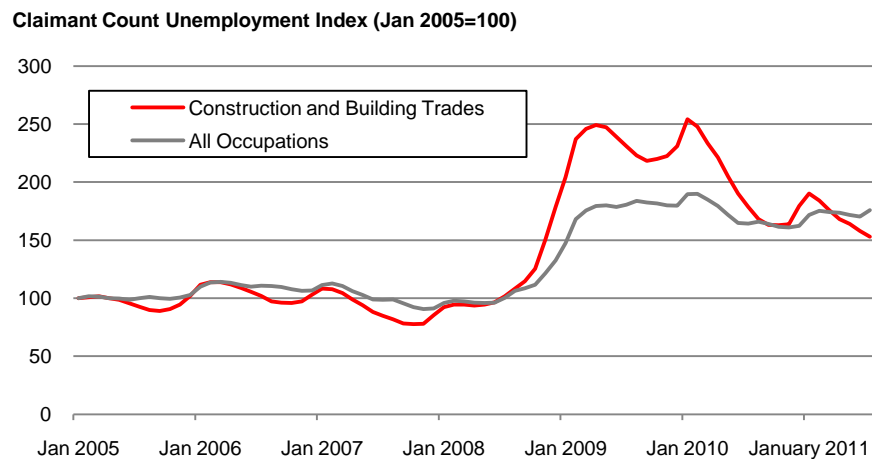
Source: "New orders in the construction industry, 2011 Q1", *Statistical Bulletin*, ONS

3.8 The spare capacity shows up in the labour market as well. Not surprisingly there has been a significant weakening of the construction sector employment base, with unemployment in Great Britain among construction related occupations rising from

⁶ Source; United Kingdom Economic Accounts 2011 Q1, table 4
⁷ New orders in the construction industry 1st quarter 2011, ONS

32,000 in October 2007 to over 100,000 in January 2010. It was still at some 63,000 – over double the pre recession figures – in July 2011. As Figure 6 shows the rise was much higher than for all occupations in the first phase of the recession⁸.

Figure 6



Source: DWP Claimant Count, ONS

3.9 Similarly the proportion of construction sector vacancies in GB left unfilled for more than four weeks at Jobcentre Plus declined from a peak of around 7,000 in October 2007 to under 2,000 in April 2010 and down to less than 1,000 in July 2011. Whereas 50% of all construction vacancies had been unfilled for more than 4 weeks in October 2007, the proportion was just 11% in July. This means that there are sufficient unemployed people with the relevant skills chasing jobs for employers to fill them relatively easily⁹.

3.10 We therefore have considerable evidence of spare capacity in this sector. The other constraint on fast expansion however might be the availability of land with planning consents (or where planning permission can be given relatively speedily).

⁸ SIC 53 is used here as a measure of the construction sector

⁹ Source: Live unfilled vacancies in construction, Great Britain, (from NOMIS, September 5, 2011)



- 3.11 Shelter analysed the annual reports of the major house builders (that typically between them build around one third of the total starts each year). They conclude that existing land banks are pretty healthy with major developers holding planning permission for at least 188,000 new homes and possibly closer to 250,000. Given their usual rate of build this is a reasonable number of years supply. Anecdotal evidence from major construction firms supports these findings¹⁰.
- 3.12 In addition the government is bringing in a new framework for planning designed to allow planning permission to move more speedily in the future¹¹ although there are differing views on the impact these changes will have and how quickly any positive effect would take to show up in the volume of starts.
- 3.13 The net result of the analysis above is that a significant expansion of housing investment is possible. It is plausible that a supply constraint exists, but it is probably somewhere above the 200,000 per year seen at the peak of the market¹². The current depressed level of new build construction is being driven by final demand. Relaxation of supply constraints on their own will only be effective if final demand is sufficient to boost housing starts.

¹⁰ See eg <http://www.cityam.com/news-and-analysis/berkeley-upbeat-sales-and-land-bank-grow>

¹¹ See <http://www.planningportal.gov.uk/planning/planningpolicyandlegislation/reform/nppf> for more details

¹² Source: Construction shortfall and government intervention in the private sector housing market (R. Carver)



4 Investment in housing versus other options

4.1 Of course investment in housing is only one potential way of boosting the economy and Ministers would need to look at how it measures up against alternatives.

4.2 We can compare investment in housing with other potential options for a fiscal stimulus against a range of criteria. The other changes might include tax changes (income tax, VAT, corporation tax), changes to benefits and current spending, and methods to encourage more investment spending in non-housing areas.

4.3 The criteria that an assessment ought to take into account include;

- speed of implementation;
- speed of effects;
- scale of effects;
- multipliers;
- 'leakage' abroad' (propensity to import); and
- additionality (eg whether public investment in housing is likely to displace private investment); and
- Other non-economic effects (not analysed here).

4.4 On all of these criteria housing scores well as the following discussion shows.

Speed of implementation

4.5 As we have seen above there is little capacity problem in this sector. Many of the skills needed could have walked away and retrained but the strong likelihood is that labour could be easily attracted back into the sector and that the skills have not gone rusty in the meantime.



- 4.6 Planning requirements should not be a drawback. One way forward would be to emulate the approach taken in the ‘Kick Start’ programme¹³. The Homes and Community Agency (HCA) helped to deliver housing and regeneration schemes that were all ready to go but whose finance had fallen apart. In that case the taps were turned on very fast¹⁴.
- 4.7 Most other investment projects take longer than this. It is hard to decide on a route for a new train line or a site for a power station or prison and the processes for getting formal approval take a long time. In the case of a major airport development, Heathrow Terminal 5, for example, the process of securing planning approval took some 8 years. Although the government has taken steps to shorten the planning process for major national infrastructure, it is never likely to be the case that these investments can be designed and built to anywhere near the timescale of housing.
- 4.8 Tax changes can in some circumstances be done very fast – for instance the rate of VAT can be changed quickly and so can National Insurance Contributions (NICs) or income tax rates¹⁵. Changes to the structure of taxation or tax credits take longer. Most changes to benefits take time to model, agree and implement. Even simple changes might require at least 6 months from announcement to implementation.

Speed of effects

- 4.9 Encouraging investment in housing, as with most construction related investment, puts money straight into the pockets of those employed to build them. It takes people from the dole queue and puts them into economically productive work so transforming them into people who add to demand. It also saves expenditure on benefits. Some of the investment goes into the supply chain, increasing the number of jobs there.

¹³ http://webarchive.nationalarchives.gov.uk/20110303161527/http://www.homesandcommunitiesco.uk/kickstart_housing.htm

¹⁴ Evidence from previous Kickstart programs suggests that this is a cost effective way of creating jobs. See eg <http://www.homesandcommunities.co.uk/news/kickstart-round-2-over-5000-new-and-affordable-homes-unlocked-first-tranche>

¹⁵ The 2008 cut in the VAT rate from 17.5% to 15% was implemented at less than one months notice.



- 4.10 Tax changes affect the incomes of lots of people in small ways. There are debates about how much of any extra disposable after tax income they will spend (hence boosting the economy) and how much they will save or use to pay down debts (good for them, but not for boosting the economy). But what is clear is that none of this will happen instantly. For most people constraints on spending would be marginally eased, not transformed, as with moving from unemployment to employment. In addition, if a tax change is announced as a temporary measure, consumers or businesses may not change their expenditure patterns at all. They may discount the change and continue behaving as before. Alternatively, they may simply bring forward expenditure that they were planning at a later date. This has typically been the effect of temporary increases to capital allowances for business investment. The problem, then, is that demand subsequently falls when the tax concession ends.

Scale of effects and multipliers

- 4.11 The scale of impact that an intervention can have depends on its direct effects and then on the associated ripples throughout the economy that it leads to (the so-called 'multipliers'). As we have discussed, the direct effects of increased investment in new housing are likely to be large. But the multipliers are also likely to be large.
- 4.12 Evidence suggests that an additional £1 of demand for construction activity generates £2.09 of economic output through the direct and indirect multiplier effects associated with construction firms purchasing goods and services from other sectors, and construction sector wages and profits being spent across the whole economy¹⁶.
- 4.13 This multiplier compares favourably to other traditionally high value sectors such as the advanced manufacturing sector 'manufacturing of medical and precision instruments' (which has a multiplier of 1.7), and the business service sectors of 'owning and dealing in real estate' (1.6) and 'banking and finance' (1.7).

¹⁶ Source; ONS Input-Output Analysis, 2002 Edition as cited in Shelter briefing 'Housing Investment, Part 1'.



4.14 More generally, fiscal multipliers from infrastructure investment are generally thought to be higher than those from tax and current spending. The OBR¹⁷ suggest that the impact multiplier is bigger for capital expenditure – about unity – than it is for other measures – that range between 0.3 and 0.6. The IMF, in March 2009, suggested a range of 0.3 to 0.6 for tax measures, 0.5 to 1.8 for capital spending and 0.3 to 1 for other spending¹⁸. This means that £1 spent on housing – a form of capital expenditure – induces more economic activity than a similar £1 spent on reducing tax.

‘Leakage’ overseas (propensity to import)

4.15 Any fiscal boost does less for the domestic economy if some of the extra demand goes into imports rather than domestic output. Clearly with tax cuts this is quite likely – given the UK’s trade deficit on goods, it is likely that much of the extra spending would be on imports and thus benefit other economies.

4.16 In housing construction the labour will all be employed in this country. Even those who are migrants still spend money in the UK and pay taxes¹⁹. The inputs will also be mainly sourced from the UK so that leakage is relatively small. In addition, profits are more likely to be retained in the UK than in sectors where foreign firms have a significant presence as the UK house building industry is dominated by UK-based (and owned) firms. Thus there is greater benefit remaining in the UK when compared to a tax cut.

Additionality

Given the weakness of private demand for new build at present, if there was to be a fast boost in housing construction, it would have to be via public sector investment or via some sort of subsidy to private demand. In normal economic circumstances, there would be justifiable concern that this would simply raise the

¹⁷ Office of Budget Responsibility Forecasts, June 2010, Table C8

¹⁸ Source: ‘Note by the Staff of the International Monetary Fund’ for G20 conference, 2009, Table 4 footnote 2 <http://www.imf.org/external/np/g20/pdf/031909a.pdf> . See also HM Treasury “Employment Impact of government intervention” 2009 http://www.hm-treasury.gov.uk/d/foi_employment_impact_paper.pdf and ‘The Job Impact of the American recovery and Reinvestment Plan’, C Romer and J Bernstein, January 2009.

¹⁹ According to the HSE about 6% of construction workers are migrants – although on big London sites that can rise to as much as 25%. <http://www.hse.gov.uk/migrantworkers/construction.htm>



demand for scarce labour and capital and lead to less houses being built in the [unsupported] private sector. However, the extent of unused capacity means there is little risk of this happening in the current circumstances.



5 Effects of investment in housing on longer term growth

5.1 Not only would investment in housing help get the economy moving, it would also have beneficial effects on the supply side of the economy that could help raise the long term trend growth rate.

5.2 Areas where the literature is clear we get benefits include improved labour mobility, better work incentives, regional and spatial advantages²⁰.

Avoiding long term damage

5.3 If unemployment persists for any length of time we are in danger of hysteresis - skills getting out of date, motivation fading and communities being damaged. All of these are a brake on the potential output of the economy and its growth rate.

5.4 Evidence from the last recession in the late 1980s/early 1990s demonstrated that it took around a decade for employment to recover to pre-recession levels. Sustained unemployment in the construction sector will have serious long term consequences on areas dependent on construction employment leaving local workers increasingly isolated from the labour market.

5.5 A further contraction of the construction sector will also have specific implications for youth unemployment and the quality of employment accessed by today's school leavers. Prior to the recession, the construction sector provided a broad range of formal training opportunities, apprenticeships and routes to well paid skilled trades and professions. With unemployment of young people recently topping 1 million, boosting a sector which is a significant provider of apprenticeships could help provide opportunities to young people out of work.

Labour mobility and business needs

5.6 Research undertaken by Shelter found that 12% of people (5.6 million) considered that housing costs had affected their ability to move for work. This increases to

²⁰

See DTZ Consulting & Research: "Housing, Economic Development and Productivity: Literature Review", January 2006, for the Department of Trade and Industry
<http://www.bis.gov.uk/files/file32669.pdf>



18% of 18-34 year olds (2.4 million)²¹. These findings are consistent with an earlier survey of English businesses undertaken by the Campaign for More and Better Homes prior to the recession²², which found that 17% of English companies believed the limited availability of housing had a negative impact on their business. This rose to 26% of companies in the South and 38% of companies in London.

- 5.7 These impacts are most acutely felt by smaller companies (19% of businesses with a turnover of between £1 million and £2 million) and those operating in the service sector (28%). Furthermore, one in five businesses regarded house prices as a constraint to business expansion in their region, rising to 44% of London firms.
- 5.8 Having adequate housing can also help with macro trade-offs between growth and inflation. The evidence suggests that house price inflation – even though not in the CPI - can often drive overall inflation in any upturn through the effect on wages and other prices.

²¹ Source; The Human Cost, Shelter, 2010

²² Source; The Impact on Business of Constraints in the Housing Market, Communicate Research, 2007



6 What kind of investment in what kind of housing?

- 6.1 Assuming that a case has been made for action to increase investment in housing as part of a stimulus package, there is the issue of how this should be done and the kinds of housing investment that the additional investment might produce.
- 6.2 The options available are wide and they include:
- Direct investment in affordable housing via the Homes and Communities Agency (and housing associations) or councils;
 - ‘kick starting’ stalled regeneration and housing projects;
 - investment in more equity share offers (like the various Homebuy products);
 - or even tax breaks for house builders.
 - Other suggestions received include a green investment bank, new towns, a clearing bank for house
- 6.3 There are choices to be made around the degree to which any boost in house building is focused around affordable housing as against housing at market prices and rents. In terms of short term benefit, this might not make much difference – it is the investment activity that is most important for stimulating demand. The choice of affordable and market priced housing might be more important in the medium to long term through any differential effects on labour mobility or work incentives.
- 6.4 The government has already taken steps that it believes will increase housing supply over time – like reforms to planning, the new homes bonus and allowing RSLs to charge up to 80% of market rate for rents. These policies may be effective in increasing housing supply but they are unlikely to operate with the scale or pace required to stimulate demand in the short term.
- 6.5 However, the government recently announced additional measures which may have a greater impact in the short term. Right to buy discounts are to be increased with the proceeds recycled into new build affordable housing. Developers will be able to take on disused land and not pay back the cost of the land until housing has been sold. The question is whether these will have the scale and speed of impact to kick start house building.



- 6.6 Analysis of the detailed options and the precise mix that the government should adopt if it takes any additional measures are outside the scope of this paper. However, in deciding on the details of any package, the government would need to take into account the issues of pace of implementation and cost-effectiveness (homes built per £1 of public money spent) as well as impacts on equity, homelessness and spatial distribution.