

**JRF programme paper:
Housing Market Taskforce**



The UK private rented sector as a source of affordable accommodation

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This paper:

- examines features of the UK private rented sector;
- investigates the impact of extending security of tenure and introducing second generation rent controls;
- assesses the potential for the private rented sector to provide an alternative to home-ownership for households who are priced out of home-ownership, or for whom risks are too high.

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1. Introduction


This paper aims to provide an assessment of the potential for the private rented sector to provide an alternative to home-ownership for households who are either priced out of home-ownership, or for whom the risks of home-ownership are too high. This statement takes owner occupation as the default tenure to which most people aspire. This seems a reasonable supposition (Wallace, 2010; CLG 2009). There is a growing interest in intermediate forms of tenure, which either involve 'soft' subsidies to below market rent accommodation or a mix of ownership and renting (Monk and Whitehead, 2010). These tenure forms are explored in another JRF paper and are not covered here; although a number of points made are relevant to that policy debate (Whitehead, 2010).

To summarise the arguments made here briefly:

- The private rented sector is relatively good at doing what it does at present, but there are limits to what it can do.
- It is unlikely to increase in relative size by much in the future, though it will grow absolutely with rising household numbers.
- It is impossible to compensate for general supply-side induced housing shortages through adjustments in the operation of specific tenures, such as renting or 'intermediate' housing.
- In situations of shortage, subsidising one group or tenure crowds out housing for others.
- Currently, the private rented sector provides lifetime homes for only a few households; instead it is a 'life style' or 'stage in life' choice.
- If private renting were to increase its role as a permanent tenure for some households, moving towards greater security of tenure or towards 'second-generation' rent controls are unlikely to improve, and will probably worsen, the housing situations of those households.
- Imposing rent and tenure security constraints in the UK would have particularly adverse effects because of the extent of general housing shortages.
- Institutional investment in rental housing is limited internationally, because of the nature of the investment and the attractiveness of the sector to small-scale investors.
- Institutional investment in the UK private rented sector is low and as a share of all rental properties is likely to remain so, without substantial, unjustifiable subsidies.

- The social costs of a lack of institutional investment in the private rented sector are small or non-existent.

The assessment here is based on looking at some features of the private rented sector; the 'what and why' of its customer base; prospects for private rented sector demand and rents; an investigation of the impact of extending security of tenure and of introducing second generation rent controls in parts of the sector; and the economics of small-scale versus institutional investors. International comparisons are used where relevant.



2. Features of the UK private rented sector

The growing importance of the private rented sector

The private rented sector ended its long secular decline following liberalisation in the late 1980s. By 2008, well over a million more English households were private renters than two decades earlier (Figure 1).

The pattern of expansion between the late 1980s and 2008 had three broad stages:

1. *Tenancies grew by around a fifth after liberalisation up to the mid-1990s.* Interestingly, this was during a period when real house prices were falling nationally, suggesting that the sector has distinct cyclical dynamics from those in owner occupation.
2. *Expansion then slowed sharply between 1997 and 2001.* This was despite the introduction of the buy-to-let mortgage in 1998 and was probably due to an increase in first-time buyers, many of whom quit renting.
3. *Rapid expansion from 2003–2008.* This period is popularly known as the ‘buy-to-let boom’. New investors entered during a period of booming rental demand and rising house prices, using mortgages that could be borrowed on similar terms to those enjoyed by owner occupiers. Rental demand increased partly because of the strength of the economy but also because rising house prices put off first-time buyers (Andrew, 2006).

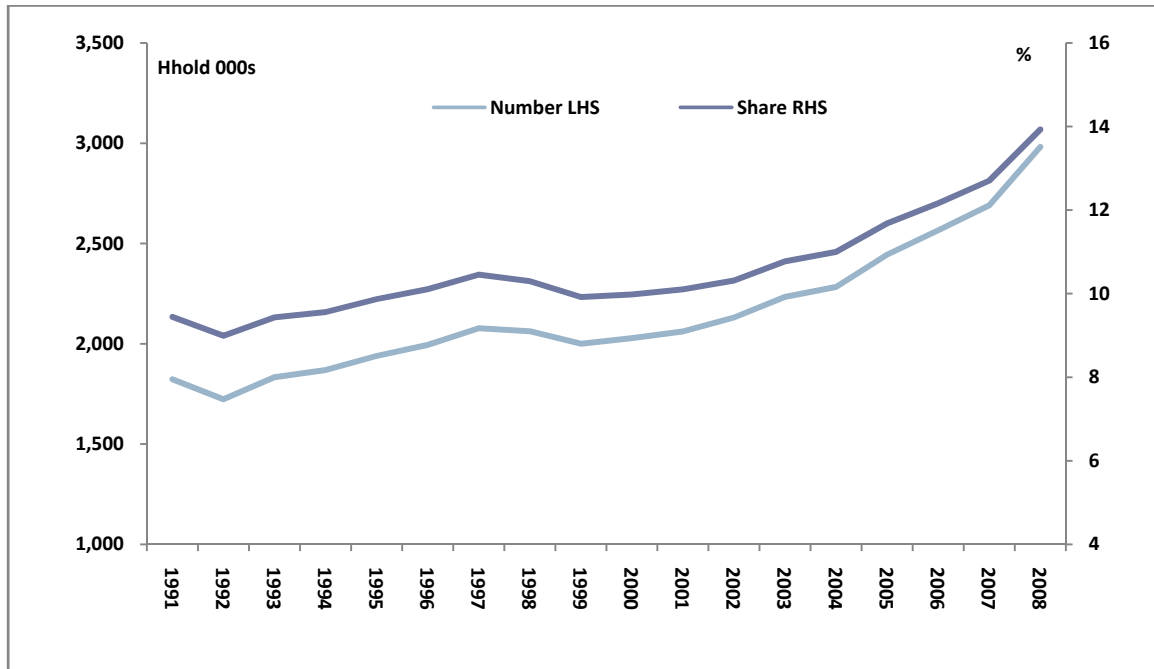
It is popularly assumed that the growth of the private rented sector over the past two decades has been supply driven, especially through the expansion of buy-to-let. Yet levels of rent and the number of tenancies are a function of the interaction of demand and supply and a strong case can be made that developments in the private rented sector, once deregulation is in place, are driven mostly by variations in demand to which supply adapts with a lag. The prime reason for this is that vacancy has a high cost to landlords and, so, supply rarely races ahead of demand. When demand falls, supply will also lag behind as it takes time to sell off properties.

Variations in demand are influenced by general economic and demographic factors and also by what is happening in owner occupation markets, which are over five times larger in scale than the private rented sector and, so, have significant impacts on cyclical variations in private rental demand. The size of the private rented sector thus depends on demand drivers within it but, in addition, on what is happening in other housing tenures as well. Supply factors will also vary cyclically across the tenures. However, there is no literature at present on the detailed cyclical relationships between renting and owning. So, in the context of this paper, it is probably best simply to accept that housing market cycles in renting and owning are different.

Whatever the cyclical dynamics, the assumption here is that owner occupation will remain for the foreseeable future the predominant housing tenure at roughly the

current percentage share that exists now. Justification for this statement is based on people's preferences, mortgage market and economic trends, and demographics.

Figure 1 Growth of the private rented sector, England



Source: CLG

Links between the cost of renting and owning

In a competitive market with 'tenure neutral' taxes and subsidies, there is a clear and simple long-run relationship between rents and the prices of dwellings in that prices are the discounted values of future net rent streams (DePasquale and Wheaton, 1996) ('net' rents take account of adequate repair costs to maintain dwellings). There are some differences in costs in owning and renting and some suggested external benefits of owner occupation and the short-run the relationship is probably more complex, as noted above.

Looking at the long-run provides an important insight, in that the cost of housing is broadly the same in either renting or owning. So, if prices are high in one of them, they will also be in the other because supply is short. This is due in the UK to insufficient land for housing and that overall supply shortage cannot be resolved by shifting what is available between the tenures. Subsidies and regulations that try to do this are ineffective, inefficient and expensive. This fundamental economic insight is of great relevance to discussions of renting and intermediate housing.

Housing demand has been growing at a much faster rate than supply for many years. As a result, national trend house prices have been rising at 2.7% in real terms a year over the past 50 years while earnings rose at only 2% (Halifax, 2010). Forecasts of even greater shortages over the next twenty years suggest that prices may rise fast relative to earnings, once the recovery is firmly in place (NHPAU,

2010). Without substantial increases in housing supply, prices go up. As house prices go up, so will rents.

The complex dimensions of consumer choices

There are important trade-offs that households make when paying for housing, because housing constitutes a complex bundle of attributes. Dwelling space, dwelling and public amenities and location are the main determinants of the relative differences between house prices. People can economise, or spend more, by altering all or any one of these characteristics. This multi-dimensionality makes it inherently difficult to discuss housing affordability issues and tenure options, because like is not necessarily being compared to like, unless care is taken.

In order to be able to economise on housing costs in the face of rising prices (or rents), in the absence of subsidies, people have three choices: limit the amount of space they use, accept worse quality accommodation, or move to a cheaper location. In such circumstances, people vary in their responses: for example, some move to cheaper locations, while others prefer to crowd up and gain the benefits of the location. Such differences may be reflected in tenure differences with, say, younger people crowding up in lower quality but centrally located rental accommodation, while others move to the suburbs to find cheaper but more spacious owner occupied accommodation. It is important from a policy analysis perspective to recognise such decisions inherent in tenure disparities.

Subsidies, policy responses and impact leakage

Subsidies offer another housing possibility; say via social housing, through which some people's housing can be provided at below market cost in a locality. Yet, unless there is additional local supply, there will be a crowding out of the housing opportunities of others. House prices will rise as 'crowded out' people chase shrinking opportunities for accommodation. As a result, everyone's housing costs increase. Prices rise because demand is enlarged, through subsidy, without any commensurate increase in supply; with the binding supply constraint being related to land.

Actions in one tenure, or part of it, may consequently have spillover effects elsewhere. So, any policy evaluation must include such potential spillover and feedback effects. Broad demand and supply situations matter a lot when discussing policy options related to one specific tenure. Moreover, the required level of subsidies to meet targets, when there is crowding out, rises over time as overall housing costs rise.

Subsidies and tax breaks also do not necessarily end up with their intended recipients. A good example was the removal of stamp duty in the March 2010 Budget for first-time buyers on properties worth under £250,000 (HM Treasury, 2010a). Given UK supply elasticities, this tax break is likely to be quickly absorbed into higher purchase prices, so that the sellers of properties rather than their first-time buyer purchasers will gain. What is more, landlords wishing to purchase homes will have to pay the resultant higher house prices. So, it could be the case that

potential first-time buyers currently living in the private rented sector may actually be worse rather than better-off because of the tax-break designed to help them move into home-ownership.

Life-cycle characteristics and the role of the private rented sector

When assessing the potential of the private rented sector to provide an alternative to home-ownership for households who are either priced out of home-ownership, or for whom the risks of home-ownership are too high, four types of 'priced-out' household need to be distinguished:

1. those that cannot become homeowners because of their current life-cycle stage i.e. young with insufficient savings;
2. those temporarily leaving owner occupation, because of say a job move or a divorce;
3. those that cannot afford owner occupation because of a temporary sharp surge in house prices, as occurred in the last housing market boom, or because of increases in deposit requirements, as has occurred since the 2007/8 credit crunch;
4. those who, because of the levels or variability of their incomes, cannot ever expect to be able to afford to become homeowners.

The role of the private rented sector in providing unsubsidised accommodation for the first three of these groups is well documented (see below). With respect to the last group, evidence is more variable. But it is important to note the role that the private rented sector plays. With that in mind, the following sections will outline the current role played by the private rented sector.

3. The demand for housing in the private rented sector

Younger and more mobile people in work are the main clients of the modern private rented sector. Over four-fifths of private tenants are in employment or higher education (Figure 2). Many are relatively prosperous, with median or higher incomes, and stay in the tenure as long as they value mobility. Taken together, private tenants have a broadly similar distribution of income to the population as a whole, with a somewhat higher share of middle and lower income groups and a markedly smaller share of those with the highest incomes (DWP Family Resources Survey 2007–2008). The share of low incomes is influenced by the fact that around 10% of tenants are students.

The average age of private tenants is much younger than that in other tenures (Figure 3). Even the fifth of private tenants that claim housing benefit tend to be far younger than the general age structure of the country's population as a whole. The proportion of renters on housing benefit has fallen to about a fifth from around a third in the mid-1990s, so that the number has not risen in line with the growth in the private rented sector as a whole.

The significance of mobility can be seen in data on moving home. The median length of a private tenancy is 1.7 years, whereas it is almost 8 years for social tenants and owner occupiers on average move only every 12 years. Of private tenants, 80% have lived in the same tenancy for five years or less. The remaining 20% includes those still living in controlled tenancies or in long-term work-linked accommodation, so that the number of long-term tenants in the free market is very small. The scale of mobility in the private rented sector is indicated by the fact that 40% of private tenants have moved at least once in the previous year (English Housing Survey 2007–08, CLG). Most of this high private rented sector mobility is driven by tenant choice rather than landlord push.

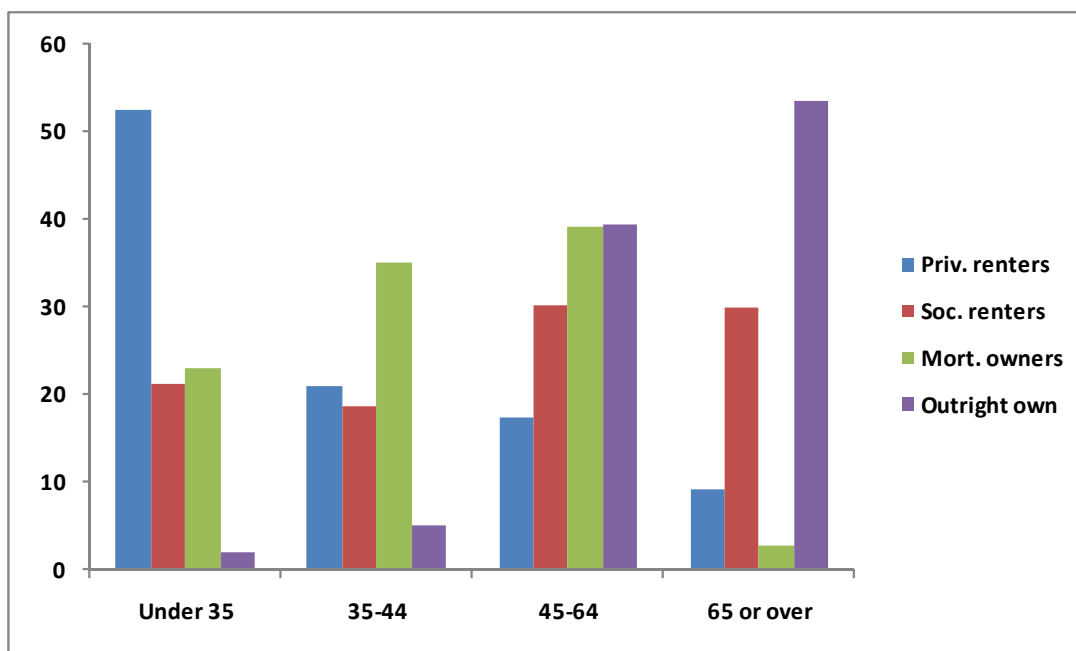
Once households become less mobile, they tend to move into owner occupation or, less commonly, into social housing. Another group of tenants, typically somewhat older, are those who have been in a relationship that has broken down and have moved into rented property as a consequence; at least for a while.

Figure 2 Economic status of private tenants and all households



*Note: Household reference person, Aug 2008. Other inactive includes students.
Source: CLG from Labour Force Survey*

Figure 3 Age distribution by tenure



*Note: Household reference person, 2007-8
Source: CLG*

So, living in the private rented sector is a life cycle stage for many tenants. As circumstances change, most become owner occupiers. This phenomenon can be seen in moving surveys; 27% of recent owner movers were previously private tenants, which is a substantial share of existing renters, given the relative absolute numbers of homeowners and private tenants (English Housing Survey 2007–8, CLG). This suggests that most private tenants become homeowners for the first or second time after some years as renters. A fifth of recently moved social tenants were also previously in the private rented sector; again suggesting that potentially eligible social tenants live in the private rented sector only for as long as necessary in order to obtain a social home.

Consequently, relatively few people at present are long-term renters in the market sector. It is hard to identify them precisely from the available data. The small sample sizes on which published private rented sector information is based mean that specific, relatively small, sub-groups within the sector are subject to large sampling errors. The available tables also only provide two-dimension cross-tabulations, which are insufficient to identify particular sub-group experience.

The main influences on whether households opt for renting or ownership relate to household characteristics. Childless, unmarried, younger households are much more likely to rent privately and those in any tenure tend to move within it rather than switch to another one. Incomes are also important, with those on higher incomes more likely to be owners. Final key factors are the ease of getting a mortgage and the size of the deposit required to purchase (Andrew and Meen, 2003).

There is a two way relationship between the availability and quality of rental accommodation and people's desire to live within it. It is now feasible for younger households to rent decent accommodation on a scale impossible for older generations. This has helped to delay the age at which people buy their own homes. One of the biggest influences on the growth of renting, however, has been worsening housing affordability, especially building up enough equity for a deposit. Rising affordability problems have delayed moves into owner occupation: the share of young adults aged between 20 and 24 entering owner occupation fell from 31% to 20% between 1991 and 2006 and from 63% to 46% for those aged from 25 to 29 between the same dates (CLG).

The prime driver of the size of the private rented sector is demand rather than supply. The growth of the private rented sector has not been associated with a rise in vacancy rates so that landlords, in the main, have not mis-forecast demand. Rather the demand drivers have been strong, especially in London and the South, due to several factors:

- *Growing numbers of households* in the age ranges with highest demands for renting, i.e. younger households. This has partly been fuelled by domestic demographics but also by immigration, because immigrants tend to be in the younger age ranges.
- *Growing affluence and associated mobility* amongst younger people has encouraged them to set up independent households.

- *Mobility requirements in some occupations* have risen.
- *Greater price barriers to entering owner occupation* and, to a lesser degree, lower availability of social housing.

If there is a demand in a free market, supply will follow as long as it is profitable to do so, and since deregulation in the late 1980s that has generally been the case in the private rented sector.

There is a common misconception that the bulk of investment in the private rented sector has been related to newly built flats, re-iterated in some of the evidence to the UK Treasury on the private rented sector (HM Treasury, 2010b). Most landlords find that tenants prefer cheaper accommodation, so unsurprisingly the vast bulk of the private rental stock is found in the older stock of housing, especially in inner city and older suburban areas, where investors have purchased and often improved existing properties (Ball, 2006).

Is private rented sector demand peaking?

Demand drivers are currently shifting in a variety of ways.

- *Mortgage availability is shrinking.* This may force some households to remain longer in the private rented sector (Housing Finance Group, 2010). However, this phenomenon should probably be viewed over a five year plus horizon, when mortgage availability should be greatly improved as the financial system gradually emerges from crisis. Mortgages may not be as easy to obtain as in the final years of the boom but they may not be that more difficult than, say, in the period 2000–2005. The cost of mortgages may rise somewhat with greater regulatory requirements, but it is the cost of entering owner occupation that is the greatest barrier, not monthly outgoings.
- *The long-run price of housing is rising* at a faster rate than earnings, so that the burden of the deposit on first-time buyers may grow somewhat. This may also force some households to remain longer in the private rented sector. However, rents will be rising as well; deterring consumption there. Off-setting this price dynamic for a few years from now may be a slower than trend growth in real house prices; longer stays at parental homes by younger people; further reliance on parental funding for first-time buyer deposits; more low-cost home-ownership (LCHO); and financial innovations that reduce the impact of down-payments.
- *Demographic forecasts* suggest that the number of younger households is going to rise at a much slower rate than that for older households: 90% of the predicted annual 252,000 increase in household numbers between now and 2031 is expected to be in 35 years and above age groups. These groups are currently not big clients of the private rented sector and are unlikely to be so in the future.¹

The demographic point is the most significant. The mobility data quoted earlier suggest that households move less as they age. Older people are particularly reluctant to move out of their homes. Staying as homeowners makes sense for them, because they are shielded from rising house prices in that way and benefit from the absence of taxation on imputed rental income. Equity release through trading down or some financial arrangement is more likely to be a preferred alternative to renting in consequence.

Demographic pressures may be partly offset by the growing housing expectations of younger households as their incomes rise over time, with some prepared to pay higher rents for better accommodation. However, as rents are likely to rise broadly in line with house prices, other renters may choose to crowd up, so that the overall effect is probably neutral.²

Weighing up the various demand factors suggests that the tenure share of private renting may stay at the same level as present, assuming that housing benefit and social housing remain broadly as they are. Private renting will still expand absolutely as overall household numbers grow.

In this analysis, a big unknown is the size of the entry barrier for first-time buyers arising because of the need for deposits. Nowadays, typical first-time buyer down payment ratios are of the order of 25% rather than the 10% seen at the end of the last boom; while debt servicing ratios of 29% indicate that monthly repayments remain above trend levels (CML). Such ratios may improve somewhat when mortgage markets free up from their currently highly constrained states in the foreseeable future but they are unlikely to bounce back to the levels of three years ago (FSA, 2009; FSA, 2010). Does this mean that far more frustrated first-time buyers will remain as renters?

The answer is yes and no but the overall conclusion strongly suggests that there will not be a surge of younger households entering or remaining in the private rented sector. This conclusion arises for a mix of the reasons already mentioned. The secular decline in first-time buyers has already occurred, down from almost 600,000 a decade ago to 200,000 in 2009, which helped to boost the size of the private rented sector over that period as observed. Any further trend reductions in first-time buyer numbers, if they do occur (which is debateable), will be from a lower base and so have less proportionate effect on the size of the private rented sector relative to owner occupation. Demographic developments do not suggest major pressures either, as already noted. Substantial future increases in the size of the private rented sector therefore seem unlikely to be realised in practice from this source.

The remaining substantial source of potential expansion of the private rented sector is if the social housing sector were reduced in size and the private rented sector took over part of its rental role, but this scenario is beyond the scope of this paper.

4. Security of tenure and rent control

Would better security of tenure assist low income groups in the private rented sector?

The use of assured shorthold tenancies (AST) is now firmly entrenched within the UK's private rented sector. Some fear that AST's lack of security creates significant long-term problems for tenants. The Rugg Report (Rugg and Rhodes, 2008) argues that a climate of uncertainty is generated for tenants far out of proportion to actual notices to quit. However, whether or not AST actually generates significant problems is debatable and there are substantial costs to having long-term tenant security, which may in practice benefit only a few households and damage prospects for others.

The evidence is mixed on the basis of international comparisons. Many European countries have greater security, either through medium-term contracts, which may be renewable, or through explicit or implicit rules. Yet they simultaneously have rent controls as well, so that the existence of greater security of tenure may be an outcome of such controls, rather than a clear benefit in its own right. By contrast, other European countries adopt a similar stance to the UK e.g. Ireland and Finland; as do most areas in the USA or Australia, even though both those countries have cohorts of long-term, moderate income renters and small or non-existent social housing sectors (Haffner *et al.*, 2008; Ball, 2009).

There are also reasons to think that market mechanisms work to enhance security implicitly as well. Tenants requiring long-term accommodation will gravitate to landlords that are happy with such arrangements; either through active search or through the fact that reluctant landlords will evict them but not supportive ones. Importantly, landlords have incentives to value good existing tenants willing to pay somewhere near the going-market rent. When tenants quit, landlords face the risk of a prolonged vacancy – vacancy rates average a month or more according to data from the Association of Residential Letting Agents. Landlords have to spend on redecoration and minor maintenance in order to attract new tenants. New tenants are also unknown quantities. They may fail to pay the rent on time or generate maintenance and administration. New tenants may themselves be suspicious of landlord motives and be more reluctant to co-operate.

Such asymmetrical information between tenant and landlord is diminished over time as each gets to know the other better. To avoid these risks associated with new tenancies, existing tenants may enjoy lower rents, especially in situations when rents are generally rising. In the literature, there are a variety of cases where it is shown that longer-term tenancies are associated with lower rents in free rental markets (see later).

Security of tenure is not offered in other important aspects of life, such as in employment. In fact, a lack of complete job security is seen as essential to create the appropriate workforce incentives. What is generally regarded as far more important in the labour market is that a plentiful supply of alternative employment exists. A

similar incentive view can be argued for in housing. The Hills Report (Hills, 2007) also argued that total security of tenure may not be ideal in social housing.

Security of tenure needs to be distinguished from a typical long-term contract. Security of tenure is asymmetrical in its terms, because under most specifications the tenant can quit at any time without incurring costs, but not the landlord (Law Commission, 2007). By contrast, typical long-term contracts outside of the housing sphere specify penalty clauses for early termination. For example, in other areas of real estate such as the commercial sector, tenants take out binding leases for long periods of time (Crosby *et al.*, 2006). Residential landlords may be more willing to negotiate binding long-term contracts that guarantee a long-term income stream, rather than negotiate on the basis of asymmetrical contracts solely guaranteeing tenants' security of tenure. The latter leave landlords with a vacancy risk as well as reduced rights of property possession, whereas the former contain only default risk. Such symmetrical contracts are commonplace when private investors rent their properties to local authorities, under private sector leasing programmes, which offer contracts for several years or more in exchange for a discount on market rents. For example, in London around 40,000 dwellings are leased in this way.³

It may be argued that social housing institutions have managed to achieve security of tenure for their tenants. However, they avoid vacancy risk in most areas by charging rents that are significantly below market levels, often backed up with housing benefit. These arrangements create queues for properties that obviate vacancy risk. Yet, in fact, those queues often do not actually remove the existence of vacancy risk but transfer it to a private landlord, in cases where new social housing tenants relocate from the private rented sector.

Security of tenure can also create unfortunate filtering rules. If tenant security exists, rational landlords are still likely to value the benefits to them that are associated with limited security of tenure. They include the low cost removal of poor paying or badly behaved tenants, or of just being able to get back vacant possession of their property when they, for example, wish to sell it. So, they are likely to act strategically and try to select types of tenant that limit the potential adverse costs of extra security. Therefore, if they are required to offer security of tenure, they will prefer to house tenants with a low probability of staying long, or who will be 'good' long-term tenants, and will consequently filter out potential applicants for whom tenure security would be more worthwhile. Paradoxically, therefore, the risk of tenure security becoming a binding constraint may shrink the housing opportunities for those wishing to live in rental property for long periods of time, especially the most vulnerable.

What is more, landlords will not have detailed information on potential tenants and so are likely to use rough-and-ready personal perceptions about particular types of tenant and their behaviour. The potential for undesirable discriminatory practices is thereby enhanced, because the perceived costs to landlords of non-discriminatory behaviour are greater if they cannot cancel tenancies at short notice.

Empirical evidence is relatively limited, but some does exist. For example, evidence has been cited for Germany, where the filtering, discriminatory effect is argued to be

strong (Basu and Emerson, 2000). Selecting only tenants that are likely to move within a relatively short period of time is one noted strategy.

Tenure security combined with rent controls can also alter tenant behaviour. One commonly cited effect is reduced mobility, because tenants do not wish to give up secure, low cost accommodation (Krol and Svorny, 2005). This can be particularly detrimental to economically vulnerable groups' participation in labour markets, because they are unlikely to search far for a job if unemployed.

Security of tenure is closely associated with rent control, because without some form of rent control landlords could simply circumvent tenure security rules by raising rents until tenants left. Rent control is common in some parts of the USA on a localised basis (Roistacher, 1992; Early, 2000), but is widespread throughout Europe on a national basis; particularly in the form of second generation rent control whereby initial contracts are freely negotiated but subsequent rent increases are linked to some marker approximating to general price inflation (Haffner *et al.*, 2008).

In some European countries, rental contracts are associated with symmetrical obligations in terms of contracts. For example, most contracts in Belgium are three year contracts, after which the landlord can regain possession, if desired, and rents can be freely renegotiated for another term otherwise. They consequently are argued to be quite close to free market conditions (Baudewyns, 2007). In contrast, security of tenure in Germany is virtually permanent in practice, because courts are reluctant to permit eviction except in circumstances of tenant default or poor behaviour and, even then, the process is costly and time consuming.

The precise consequences on housing investment of both security of tenure and rent controls depend on housing supply elasticities. If housing supply is relatively plentiful and controlled rents are not held down by some exceptionally strong price control, the benefits to tenants of staying in secure accommodation in relation to a freer rental contract situation may be limited, because they can potentially easily move to an equivalent free market property. The costs to landlords are thereby lowered by the greater probability that tenants will do so.

Where supply responses are good, long-term market rent rises are likely to be limited; whereas in places where demand strongly outpaces supply, the difference between controlled and free market rents is going to be greater. This means that the incentive of tenants to stay in their existing tenancies is higher, while the interest of landlords in selecting tenants who move on rapidly is all the more substantial.

Another crucial factor is the local supply and demand balance. Where the demand for rental housing is falling relative to supply, most of the constraints discussed above would not be binding. This could occur possibly because of a movement of more prosperous households out from rental (inner city) districts to (owner occupier) suburbs. This has taken place in many cities in advanced economies at various stages over the past fifty years. In some cases, such as Brussels, that situation is still occurring. There might also be quite long-term national declines in house prices and rents because of over-supply, which again makes the constraints non-binding. This happened in most of Germany for a decade after 1996 and also in Switzerland and Austria for an extended period around the same time.⁴

Another potential influence is the ease with which rental housing can be converted into owner occupied property. In Italy, there has been a large-scale transfer of rental flats into owner occupation, so that the home-ownership rate has risen to 80%. Rent laws changed in the late 1970s and the policy inadvertently enabled landlords to sell out. The Fair Rent Act of 1978 established a common four year renewable lease and continued rent controls. This made the dwellings far more valuable in owner occupation than in renting and enabled landlords to sell out when leases came up for their four year renewals. A similar sort of process has been occurring in Sweden and to a lesser degree Denmark for the past ten years. Blocks of previously rented properties have been converted into tenant co-operative owner flats, which is a slightly complex, institutionally determined way of creating *de facto* owner occupied flats out of previously low return, secure tenure rental property. This 'tenant owner' tenure now represents over 20% of the Swedish housing stock, and more in its major cities.

Thus, the impact of security of tenure depends on the length of rental contracts; their symmetry in terms of obligation between landlord and tenant; the ease with which landlords can remove tenants, if desired, at the end of contracts; the type of rent control mechanism that is associated with security; the price elasticity of housing supply; the local demand and supply balance; and the ability to transfer private rental housing into other tenures. Undoubtedly, with such a large number of potential variables, the overall consequences are likely to be highly variable when estimating either the impact on housing investment or the return landlords would require in order to offer greater security of tenure.

One clear conclusion to emerge is that the adverse impact on investment would be far worse (and the returns required by landlords for more security greater) in situations of considerable housing shortages and high housing costs. A corollary, given poor British supply responsiveness, is therefore that the consequences would probably be adverse if adopted in the UK but still highly variable across British cities and particularly bad in London, with its high privately rented share.

It is by no means clear that the introduction of greater security of tenure would offer benefits to long-term, potentially vulnerable, private tenants. In fact, the market consequences of introducing such regulations may well make them worse off, as they would face diminished supply and be discriminated against in competition for what remains. Any inducements to encourage greater security of tenure are consequently likely to be ineffective in meeting their stated aims.

Would second generation rent controls offer benefits?

The previous section was vague on the precise content of rent control. Some types have been grouped together and termed 'second generation' rent control, which is supposed to be smarter than the 'first generation' fixing of rents at the nominal level of a particular date in an era of rising price inflation, which then rapidly erodes their real value (Arnott, 1995).

There are three characteristics of second-generation rent control:

1. free market agreement of initial rents;

2. subsequent 'cost-based' rent increases only; and
3. security of tenure for sitting tenants for fixed or indefinite time periods.

Together they imply a particular pattern of rent adjustment. However, landlords and current and potential tenants react to the existence of such controls. The consequences are that the apparent tenant benefits of second generation rent control may be limited.

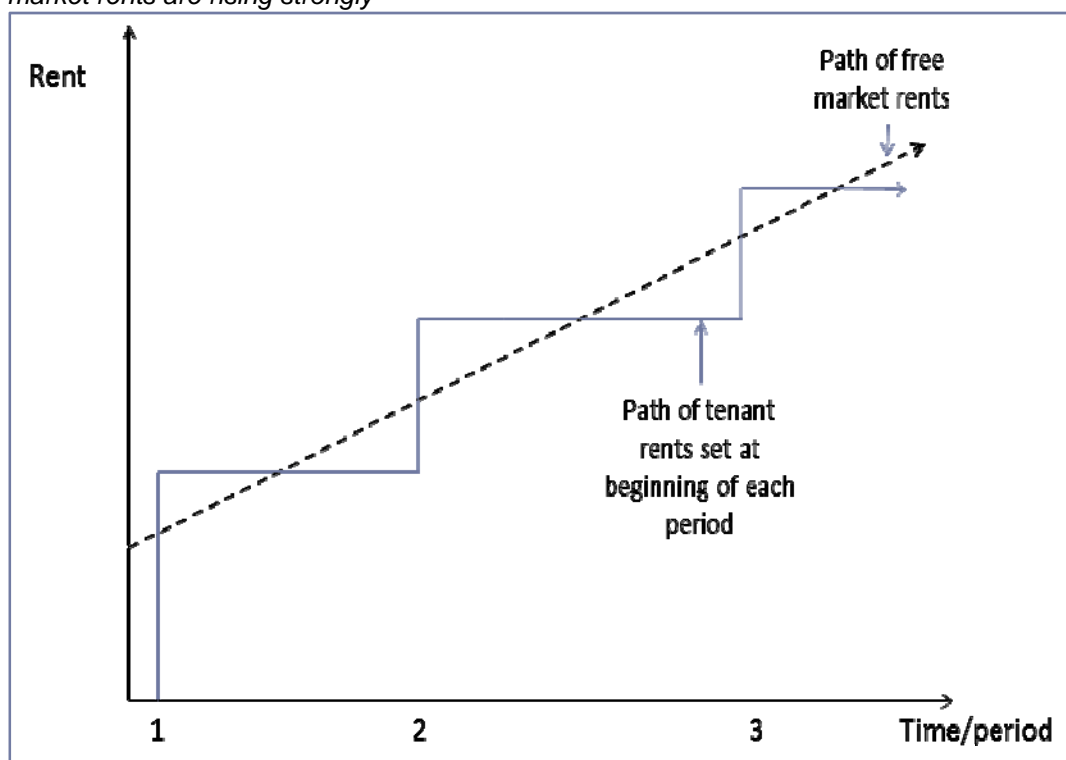
This can be seen with a simple sequence of argument. Initially, assume that everyone has full information. With perfect foresight about the time a tenant is going to stay and perfect forecasts of future rents, landlords would ask for and new tenants would accept rents that match the discounted flow of rent in a free market over the time of the tenancy minus the permitted increases in rents during the tenancy. In a context of rising rents, initial rents would be higher than market rents because the rent control measure means that landlords will front-load rents. This pattern of rent change is illustrated in Figure 4. Each tenancy lasts a fixed period of, say, three years and rents are not permitted to increase during that period. At the start of the period, when the rent is negotiated with a new tenant, the rent is higher than the market one and then declines relative to it over the contract period, only to rise above it when rents are negotiated again.

In a competitive market, landlords will not earn excess returns through this strategy, because average landlord net returns are influenced by the flow of investment into the rental sector, which will continue until it equals the risk-weighted prevailing return on all investments.

Apart from the altered pattern of rent payments, the overall effect of such rent control legislation in the perfect foresight context on housing building, trend rent levels and maintenance standards is limited. This is primarily because landlords have set rents that incorporate all potential tenant rent reduction gains occurring during the course of the controlled tenancy (McFarlane, 2003). But, at the same time, the point of having the legislation itself is considerably diminished as well.

Figure 4 The growth of rents under second-generation rent control illustrated

Tenancy starts in period 1 and rents are reset each 'period' of, say, 3 years duration, at a time when market rents are rising strongly



In the more general situation of uncertainty, the impact of second-generation rent regimes is less clear than in the world of perfect foresight. Rent controls act as a barrier to unexpected increases in rents. Obviously, because they live in the real world, tenants only demand rent control legislation in situations of uncertainty rather than of perfect foresight. But the principle that landlords will try and compensate themselves for any potential loss of return by front-loading the rents agreed with new tenants still prevails. In effect, tenants pay an initial 'insurance premium' for having fixed rents during a given period, whether they want the resultant fixed rent or not. For example, research has found that tenants living in second-generation rent control properties in New York initially pay higher rents than those in the free market sector but tend to stay longer and enjoy increasingly lower than market rents as the lengths of their tenancies increase (Nagy, 1997).

The more landlords bear the costs of uncertainty over future real rent increases and inflation and the less they know about the length of time a tenant is going to stay, the higher initial rents are likely to be set in order to compensate them for any potential expected loss of return. As a corollary, less housing will be supplied on the rental market unless landlords are confident of earning sufficient return.

Moreover, the tenant selection effects discussed earlier will operate so that landlords are likely to prefer applicants that they expect will stay only a short-time or be 'good' long-term ones when tenants have a right to remain in the property for long periods of time. Landlords will consequently tend to discriminate against riskier or potentially more costly households with a higher probability of staying for a long-time. Typically, younger and childless households are likely to stay for a shorter time and sub-groups of them are perceived as good long-term tenants. Therefore, other types of household may find it particularly difficult to find accommodation because of landlord fears that they will stay or be high cost. So, they may be forced to move less frequently, perhaps only be able to rent in a higher priced 'free' sector, and stay in worse accommodation because of lower market opportunities.

What is more, despite their attempts at broad categorisation of tenant types, landlords will still not know which tenants are actually going to stay longer. There is asymmetrical information, because tenants will have much clearer views of their plans. An adverse selection situation may well occur as a result, with higher equilibrium rents for all and lower supply compared to a free market context (Basu and Emerson, 2000).

5. Investment in the private rented sector

Who invests in UK rental housing? Mainly small-scale landlords

Most residential investment is owned by private individuals in one form or another. This is often put down to such motives as speculation on house prices but the private rented sector across the world is, and has always tended to be, a small individual investor sphere of activity, especially in free market contexts. The principal causes are economic, related to the nature of the rental business and the investment characteristics of the asset, as is explored further below.

Three-quarters of English landlords are private individuals and couples; about 10% are property companies and the rest a mix of other organisations (CLG, 2006). This small-scale characteristic was preponderant in the private rented sector's heyday, prior to 1914 (Daunton, 1983; Ball and Sunderland, 2001), and has been reasserting itself over the past two decades as residential renting has once again become an attractive investment. In the mid-1990s, less than half of landlords were individuals but the long housing boom saw many firms sell up or run down their property holdings, while buy-to-let and rapidly rising house prices encouraged many thousands of new investors to become landlords.

Surveys suggest that many landlords own only one or two properties, giving rise to the impression the majority of tenants' landlords are small scale investors. However, the growth of the small landlord should not be exaggerated precisely because most of them own only one or two properties, while larger investors and companies each own many, so that ownership of the stock is probably still concentrated amongst those that have at least ten or more properties each.⁵ This ownership structure blurs the oft-made distinction between small, 'amateur' and larger 'professional' landlords.

When asked, only a quarter of landlords actually regard housing as their prime source of income. Surveys have also suggested that landlords have different motives, with some less return-oriented than others. Self-definition may be a worry as people tend to want to be seen as 'nice' rather than 'money-grabbing'. But even if this behavioural difference is true amongst investors, rents and rental housing supply are determined at the margin, which prevailing market rates of return are more likely to indicate than some putative 'satisficing' one. There may be some filtering within the market of particular tenants living in properties owned by specific types of landlord but that is unlikely to alter market outcomes much. Moreover, it must be questionable whether the behavioural experiment can be extended to one where all those claiming to be willing to accept lower returns for social or other reasons can be grouped together and actually given lower returns. In other words, it is risky to base analysis and policy on potentially uncertain beliefs in investor altruism.

In the UK, private landlordism has come to be associated with buy-to-let mortgages, yet the roughly one million buy-to-let mortgages in existence account for only around a third of private tenancies. Larger landlords will typically take out other types of residential or commercial mortgages, on which there is far less information. In addition, it is likely that much of the private rented sector is held by individuals with

no mortgage debt on some or all of their properties. However, many own multiple properties and have mortgages on some of them.

Given high house prices, the values of investor portfolios can be substantial. Lower quartile (i.e. the price of a dwelling at the 25% point in the house price hierarchy) house prices are likely to reflect typical landlord investments. In the South East in 2008 it was £162,000, so that a landlord portfolio of ten dwellings at that price would be worth £1.6m and a portfolio of a 100 would be worth £16m.

Residential renting offers flexible leverage and labour-oriented opportunities to investors, as well as potential tax benefits. (The tax situation varies widely across countries). Small to medium-sized landlords, holding portfolios of from 10 to around 100 or so properties seem to be cost competitive relative to larger ones over wide portions of the rental housing stock.⁶ They can flexibly invest their own time; do not have high overheads; can move fast in response to market signals; and the relatively larger ones holding scores of properties can easily scatter their investments over a variety of local markets and thereby spread their risks. In particular, small and medium-sized enterprises can compete effectively with larger enterprises within the diverse and scattered stock of properties that constitutes most of the UK private rental stock.

The majority of rental housing is spread around neighbourhoods of quite old, terraced and semi-detached houses and flat conversions within this house type (Ball, 2008; Glascock and Turnbull, 1994). New properties in blocks of flats – though often thought to be typical buy-to-let territory – are, in fact, comparatively rare within the private rental stock. New rental properties are often derived from renovations and conversions of previously single-family properties into flats. This has the spin-off benefit of making intensive use of the existing stock in places where it might be otherwise underutilised and poorly maintained. Such conversions and modest upgrades are often found in neighbourhoods of relatively moderately priced properties. This can assist in regeneration and in avoiding neighbourhoods slipping over into cumulative decline.

If, as there seem to be, limited economies of scale in the business, many small landlords can offer as good a service as larger ones and be competitive. Current survey evidence does not suggest that larger private landlords or social housing institutions have more satisfied tenants than small ones (CLG, 2006; Rugg and Rhodes, 2008).

The future of buy-to-let investment

The returns to being a landlord have come down since the end of the housing market boom, because capital gains have been diminished or even have turned negative. Yet, they remain attractive relative to other asset classes. Appropriately leveraged investments and low capital gains taxation also add to a tax-efficient element.

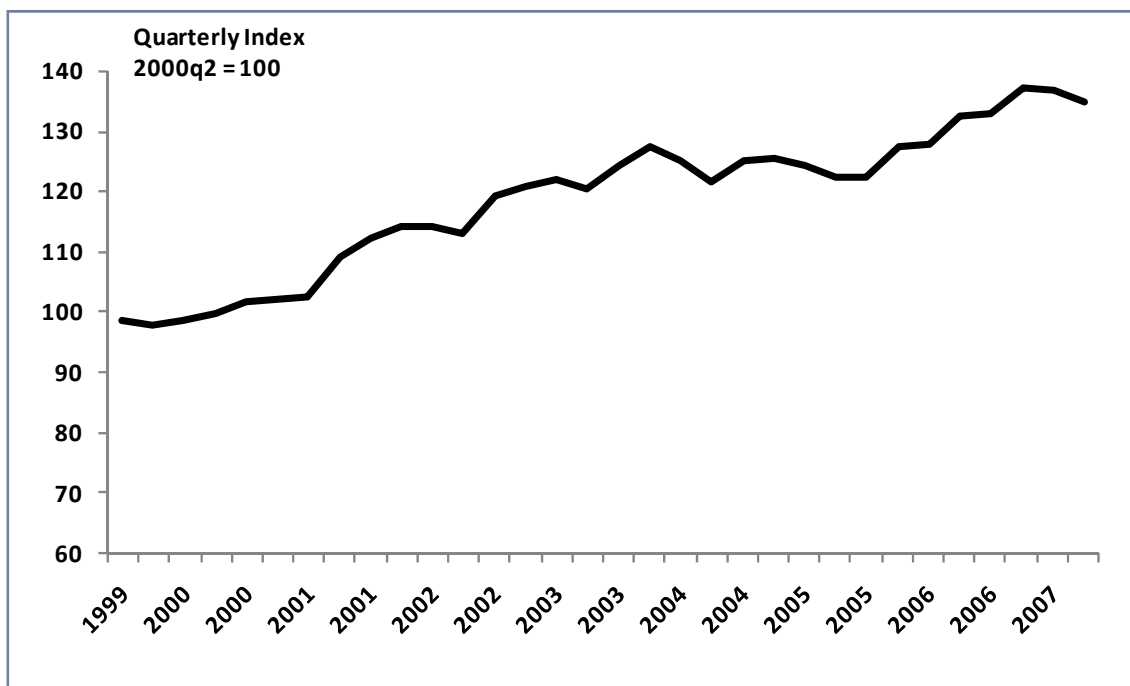
In part, the future attractiveness of rental investment will obviously depend on rent developments. Earlier, it was argued that they are closely linked to general house price trends over the long-run and, so, are likely to rise significantly in real terms in Britain. However, the cyclical behaviour of private rents differs from user costs in

owner occupation, so it is worth examining recent rent trends in more detail. Unfortunately, rent data are poor, so only broad indications can be given. Few data are quality-adjusted and most are based on quite small samples. Yet, they suggest some interesting and plausible developments.

The now-ceased Communities and Local Government experimental rent index suggests that rents rose by almost 40% between 2000 and 2007, substantially above general price inflation (Figure 5). Information from the Association of Residential Lettings Agents (ARLA) suggests a similar pattern of rents, rising by around a fifth between 2003 and 2007. The Treasury has suggested that the rise in rents during that period was comparable to that in earnings, though that may be an underestimate (HM Treasury, 2010c).

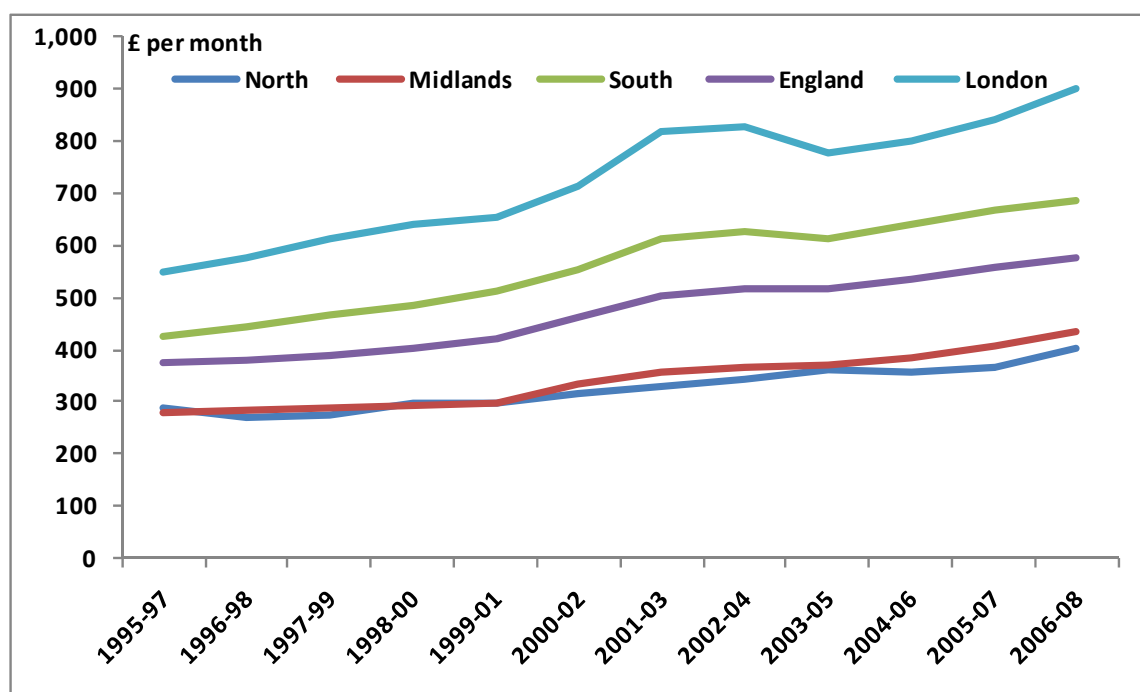
The English Housing Survey provides information on average monthly rent payments. They are not the same as rents, because the quality of the accommodation purchased over time may vary, but they show interesting regional variations (Figure 6). Rent levels in the Midlands and North are broadly similar but they are significantly higher in the South East and London. What is more, rent payments in the South and London have increased at a faster rate over time, so that they have diverged regionally in a similar way to house prices.

Figure 5 Rents 1999 q1 – 2007 q1



Source: *Experimental Rent Index, CLG. Ceased 2007 q1*

Figure 6 Average monthly rent payments by region 1995–2008



Note: South includes London
 Source: English Housing Survey

The private rented sector was affected by the downturn, as was the rest of the housing market. Market surveys by the Royal Institution for Chartered Surveyors suggest that rental demand increased during the downswing as the flow of households into owner occupation tumbled, but that, at the same time, the supply from frustrated sellers rose even faster, putting downward pressure on rents. The Findaproperty mix-adjusted rent index suggests that asking rents fell by around 7% during the downswing, significantly less than for house prices, and were recovering during 2010 as frustrated sellers withdrew their properties from renting in light of the general housing market recovery.⁷

It is unlikely that the whole of variation can be attributed to supply factors, as recessions lower demand as well. However, experience in the rental market suggests that the general supposition that rents are stickier than house prices held true during the recent recession.

Overall, the prospects for rents are that they will continue to rise. This will be driven by the general housing shortage, which has been exacerbated by the collapse in new building and its likely slow recovery (Ball, 2010b). Moreover, as rents grew at a much slower rate than house prices during the boom years and house prices have not fallen back that much, rents may accelerate for a while once the recovery is in place. This may be especially true if a significant number of first-time buyers are forced to delay purchase because of deposit requirements and, hence, remain longer as renters.

Mortgage funding is a potential constraint on buy-to-let investment in the future in line with general constraints in the mortgage market. The number of buy-to-let mortgages on offer fell dramatically during the financial crisis, as non-deposit bank providers withdrew from the market and the main lender had to be rescued by government (FSA, 2009). However, there were indications in 2010 that mortgage availability was improving. Many landlords are in a position to borrow, given the low aggregate loan-to-value ratio that exists in the private rented sector. Default rates were much lower than some had expected and were falling again by the end of 2009, according to the Council for Mortgage Lenders. In addition, as noted earlier, larger private investors will make recourse to other types of mortgage product and if they have considerable equity be particularly low risk. Finance problems for small-scale buy-to-let and new entrants may consequently consolidate rental property ownership amongst the group of investors with ten or more properties.

Though the mortgage market has yet to recover fully, there are considerable grounds for assuming that the private rented sector remains an attractive and feasible investment option for buy-to-let and other small-scale investors. Demand is there. The tax benefits relative to other investments have improved, as income taxes have risen. Rents are rising again and likely to continue to rise in the future. Finance is a constraint but the relatively low leverage of the sector as a whole suggests that investment options can be realised. Where there may be continued weakness is in the North and the Midlands and some city centres where investors bought new build, which is too expensive for typical tenants.

The role of large investors in the private rented sector internationally

The private rented sector is generally a small-scale operation around the world. This is the case in Australia, the USA and Europe as well as in the UK. Institutional investors exist in many countries but they tend to have special characteristics; operate in particular parts of the rental market; and have small overall market shares.

The USA is an illustrative example. Table 1 shows the ownership structure of rental housing in the USA. It shows that only around 8% of the stock is owned by large-scale investors, despite a tax-friendly environment and the potential for widespread initiatives at state and local as well as the national level. However, there are some major firms. They generally own and manage large, standardised apartment blocks for young, middle-low income households but, given the overall size of the US rental housing stock, their impact is still small in aggregate (Jones, 2007).

Residential Real Estate Investment Trusts (REITs) have failed to make a significant impact in US rental housing, with only 1% of the stock. A focus on the mobile, affluent market has been the experience and REITs have been active in the growth cities, especially in the south and west. They have, however, had little impact on private rental housing in the older industrial cities. The key is that REITs in the US are dividend driven vehicles and older cities, where the need for affordable housing is strong, do not have clients that can pay for new REIT housing. However, growth areas such as Dallas and San Diego have a younger wealthier clientele who want more upscale housing and demand flexibility of terms: e.g., month-to-month leases

after an initial six or twelve month base. REITs can and have provided rental housing to this segment of the market. These growth cities also have the demand to afford large-scale projects that ideally fit the REIT structure of funding and management (Ball and Glascock, 2005).

Table 1 Characteristics of owners of multi-family properties in the USA

Type of owner (%, numbers do not add to 100)	Total US	Units:		
		Less than 5 units	5-49 units	50+ units
Individual investors, husband/wife	86	90	74	31
Trustee for estate	2	2	3	1
Limited partnership	3	2	6	25
General partnership	3	2	5	13
Real estate investment trust (REIT)	1	1	1	3
Real estate corporation	2	1	4	11
Other corporation	1	1	3	6
Non-profit/church-related institution	1	0	2	6
Owner residence on this property	24	27	10	3
Owner owns one rental property	48	52	30	15

Source: US Bureau of Census

Residential REITs hardly exist in Europe. The one in Belgium has remained a small niche player. When German REITs were introduced several years ago, they were explicitly restricted from active involvement in the residential sector after strong lobbying by those that feared they would be less tenant friendly than existing landlord owners (Ball, 2010a). This highlights the fact that the idea of superior service from large-scale providers may not be believed by tenants, who in the German case were frightened, rightly or wrongly, that the bottom line would take precedence over their interests.

Large-scale investors exist in Germany because of the stipulations of social housing legislation, which converts social housing to private ownership after a stipulated time period, and due to privatisations by municipalities and employer-owned estates. Some of these were bought up by foreign investors with the aim of upgrading and converting properties through tenant purchase. In the main, these investments have not proved to be particularly successful, with tenants reluctant to take on additional costs. A number of investors sold out after only a few years (Ball, 2010a). Elsewhere, insurance companies have been pulling out of the private rented sector due to unattractive returns, as in Finland (Loikkanen and Lonnqvist, 2007).

In the Netherlands, financial institutions own less than 5% of the housing stock, concentrating on the upper market 'free rent' sectors. Rabo Bank has a major real estate division, which includes residential and an active development arm within its portfolio. It operates across much of Europe. This indicates that it is possible for financial institutions to build up successful real estate operations, though Rabo Bank has a long historical background in the area. It is notable that it spreads risks by being active across a wide range of real estate activities across a variety of locations, while retaining a specialist core in the Netherlands and links with social housing institutions.

Switzerland is virtually unique in that its major pension and insurance institutions have substantial holdings in Swiss rental property. Switzerland, of course, is renowned for its high share of private rental housing at almost 70% of the housing stock. Yet, even in Switzerland the majority of rental properties are owned by small-scale individual landlords. It is unclear why institutions own such atypically large holdings but it may well relate to taxation, regulatory matters and corporatist style state-business relations. The existence of large-scale investors does not lead to cheap accommodation. A recent study identified the high price of Swiss housing as a reason for the low home-ownership rate (Bourassa *et al.*, 2009). It is worth noting from the Swiss case that a preponderance of renting did not lead to housing market stability – with a substantial market crash occurring in the second half of the 1990s.

Constraints on large-scale investor roles in the private rented sector

The biggest constraint on large investor involvement in the private rented sector is their relative competitive position. The predominant mix of private rental property and the costs of managing it often favour small-scale landlords.

There are also problems with regard to the typical rental property. There is substantial ‘churn’ with properties being bought and sold by landlords. They sell to each other as well as sell to and buy from owner occupiers and, additionally but less so, from housebuilders. It is consequently impossible to identify a given rental stock but rather a changing pattern of private rental tenancies within the UK’s total housing stock. This trading pattern is not conducive to the operations of large-scale investors. Typically, they want to hold a large block of property as a unit over the long-term; although companies like Grainger have a trading role as well which often involves selling previously regulated rental stock (Jones, 2007).

There are segments where large-scale investors are likely to have clear competitive edges in residential investment. Such opportunities probably exist mainly when scale economies or enhanced skill sets, or both in combination, create distinctive and cost-effective rental products. In other words, large residential operators can prosper particularly well where they can take advantage of potential scale-advantages arising through branding, in purchasing, via specific forms of quality control or in other management fields.

Empirical evidence in the UK of such investment possibilities already exists and its potential for expansion is shown by the several new fields of direct residential investment developed by large-scale investors over the past decade. A number of firms and funds now exist with £100-500m portfolios of UK residential property. They have grown to be major players in such areas as accommodation for students, key workers and retirees. Other growth areas with significant potential are serviced apartments for mobile, high-income professionals and health-care related housing.

Student housing illustrates the scale and growth of such investment opportunities. Many students rent accommodation from small-scale landlords, with some neighbourhoods in university towns almost entirely used for student housing. Even so, there are over 450,000 bed spaces in student halls and over a 130,000 of them are in halls owned and run by private firms. This market was estimated to be worth

£6.6bn in 2007, according to Savills, and had almost doubled in value over the previous two years. This indicates the scale of new investment taking place and forecasts point to further strong growth over the next few years. Growth is being encouraged by substantial increases in rents over the same period, due in part to the greater provision of en-suite accommodation (Savills, 2007). The small-scale and the large investor both operate in the student housing market and the large-scale ones have been able to prosper due to an ability to differentiate their product and offer a distinctive service package.

Generally, large-scale investors regard residential property less favourably than commercial property because of several characteristics of the asset class. Not all of these will hold for all investors but taken together they offer a picture of a less attractive asset class than commercial property:

- high investment transaction costs linked to the too-small for them scale of residential investments;
- a lack of matching investment income with investor liabilities, because returns contain a significant capital element that cannot be realised without selling the properties;
- intensive management and maintenance;
- high tenant turnover and vacancy rates;
- potential reputational issues;
- illiquid, thin markets that make it difficult to sell blocks of flats on a timely basis or to work out what is their fair market value at some points of the property cycle.

Yet, despite these drawbacks, advantages remain in the long-run capital returns associated with housing and the relatively uncorrelated nature of those returns with other types of property, which facilitates portfolio diversification.

The problem for large investors remains of how to mobilise those benefits, while minimising the costs. Indirect residential investment (i.e. holding the shares of property companies that own rental stock) offers some benefits. Yet a recent study argued that a low level equilibrium may exist because of problems in matching the demand for and supply of residential property. On the supply-side, the existence of firms and funds holding residential assets requires willing purchasers of their offerings but, on the demand-side, potential investors may be wary unless there are truly deep and transparent markets in indirect residential, which there are not at present. A chicken-and-egg situation may easily arise, leading to a relatively low level of investment activity (Ball, 2007). However, this is not a problem that governments can easily resolve and the social returns from doing so may in any case be limited. Markets may themselves overcome some market failures, especially when given time.

There have been policy attempts to increase large scale investor interest in the past but these have foundered, partly because of the complexity and narrowness of the subsidy offer but also because they did not overcome investor concerns (Crook and Kemp, 1999). Residential REITs have been absent to date in the UK and they are relatively small in scale in other countries.

There has been recent investor interest. For example, the Aviva insurance group has been contemplating launching a £1bn fund to invest in blocks of a hundred or so units in regeneration areas in the South East and near transport hubs.⁸ The aim is to introduce mass produced rental housing, which is common in some US cities, for middle market tenants such as younger office workers. However, even if there were 10 or 20 developments like this, they would have a relatively small impact on the rental market as a whole. All the same, such developments are to be welcomed as they offer new supply at a time of considerable constraints. This supply is not targeted at the lower end of the market but obviously helps ease rent pressures by providing extra accommodation, which can be particularly beneficial in local areas of high demand.

In summary, there are benefits for large-scale investors in residential – and this is encouraging some current interest – but there are also disadvantages and substantial competition for smaller-scale landlords. This relative imbalance is likely to explain the comparatively low scale of investor activity and, also, the failure of previous policy attempts to expand large-scale investment, as much as any inherent issues with them as policies.

Conclusions

The private rented sector works comparatively well at what it does. This statement may seem unnecessary to make but the UK has only had a free rental market for a relatively short period of time and institutional arrangements have only become embedded over the past decade. There is also a continuing chorus of criticism and requests for greater regulation, some of which have been successful.

As no housing system is perfect, the most appropriate policy question should be to ask whether alternatives to a low regulation stance in relation the private rented sector would be cost-effectively better? For example, Scotland introduced landlord registration some years ago. Has this raised the quality and quantity of the rental offer there compared to England? Similarly, has HMO (House in Multiple Occupation) registration legislation actually achieved its aims? How have new local powers in England to limit high concentrations of shared rented homes affected local housing markets? No worthwhile research has been undertaken on these questions but scepticism regarding improvement seems most appropriate.

Regulations and the threat of more regulation put off investors. This is generally due to the costs of compliance. Rogues ignore rules, so it has to be demonstrated that the total costs of compliance by all landlords are outweighed by improvement in the quality offer by the few. The paradox may arise where regulations deter good quality investors and the resultant accommodation shortages generate substantial financial incentives for those prepared to flout the rules. In those situations, the outcome of legislation would then be the opposite of what was intended with the quality offer falling sharply. Feedback effects are important and have been the basis of the criticisms made here of enforced security of tenure and rent controls.

Renting cannot resolve housing shortages. These are determined by the overall relation between demand and supply, which currently lead to chronic shortages in the UK across the whole range of the market. If rents rise in the private rented sector in the future, as they are likely to, the cause will be these growing shortages. Simultaneously, some tenants in order to economise in the face of rising rents will want to crowd up more and take lower quality accommodation. So, the prognosis for housing conditions without improved housing supply is bleak.

In addition, subsidising specific types of housing can crowd out other options, including free-market renting. The policy prescriptions with respect to housing are, therefore, as complex as ever and there is a need to look out for spillover and feedback effects in other parts of the housing system when promoting one policy measure. For example, intermediate housing schemes may dent private rented supply.

In policy terms, the case for supporting large-scale investor involvement in the private rented sector seems scant. Of course, given the chronic housing shortage, any new supply of rental property is to be welcomed, but with regard to private investors targeting the general rental market there seems little justification for policy intervention. Solvable market failures or potentially merit-worthy social redistribution do not exist.

It may be the case that large-investors begin to find residential investment more attractive but, if they do, the outcomes should be left to market forces. Demand in the private rented sector is currently being met and there is unlikely to be a substantial increase in demand in the near future. If this is the case, any expansion of large-scale investors would be at the expense of provision by smaller scale ones i.e. there would be a supply crowding out effect. Whether this would be a social benefit or not would depend on competition and the reaction of the targeted groups of tenants. The outcome would not be the replacement of the bottom quality end of the private rented sector with new flats but rather a question of whether relatively well-off young mobile tenants would prefer the current rental offer they face to a probably somewhat more expensive package. Their decisions will be based on trade-offs regarding space standards, amenities and location for the time periods before most of them become homeowners. To date, most have opted for rental accommodation in the existing stock, provided by a small landlord. It will be interesting to see whether new providers can persuade enough of them to switch to their schemes. Yet, it is obviously best to let those potential tenants decide themselves rather than to distort the relative costs of the options through tax breaks and other forms of subsidy.

So, the UK Treasury's recent decision not to support subsidy to large-scale financial institutions in the private rented sector seems appropriate (HM Treasury, 2010b) but there remain substantial regulatory barriers to development, including within the planning system, that need to be addressed if new supply is to be achieved. Focusing on them would save public expenditure with potentially large housing supply payoffs.

Notes

1. Housing forecasts based on 2006 projections, Communities and Local Government.
2. Income and substitution effects are not well-calibrated in the private rented sector. Demand functions for renters do not exist in the same way as for owner occupiers, because of data limitations, so forecasting exercises about future renter demand cannot be very precise.
3. According to the Find-a-Property website.
4. See Ball, *European Housing Review*, RICS, various issues.
5. Unfortunately, the data do not allow this important question to be adequately answered.
6. There are no detailed studies of private landlord cost functions.
7. See <http://www.findaproperty.com/rental-index.aspx>
8. Financial Times 27 September 2010.

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