NEF working paper
Economic inequality and house prices in the UK

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Contents

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Summary

The gap between the housing-haves and the housing have-nots is growing rapidly. House prices have soared in the past three decades, as has the gap in earnings and wealth between the richest and poorest. The positive correlation between these trends is unlikely to be a simple coincidence. The growth in incomes and wealth at the top may well be inflating house prices and locking out a growing share of the population. Policy makers are currently attempting to paper over structural problems in the housing market with short-term fixes like the Help to Buy scheme. To sustainably address the housing market crisis we must tackle root drivers, which includes economic inequality.

It is well known and accepted that how much you earn and your wealth dictates your ability to access the housing market. It is also well established that the size and physical condition of your home, whether you own it or not, and its location will affect your, and your children's life outcomes. As such, the housing market can often perpetuate existing inequalities in society. These relationships are widely understood and evidenced, but what is not currently considered is if, rather than just a passive reflection of disparities in access to decent housing, economic inequality is an active factor distorting the housing market.

This working paper aims to begin a much-needed discussion on if and how income and wealth polarisation is an explanatory factor in understanding why the housing market is failing to provide affordable housing for all. Multiple policy prescriptions – including incentives to housing developers, fewer planning restrictions, greater access to mortgages and most recently the Help to Buy scheme – have been applied to the housing market for the past 20 years with very little success. We suggest that this is because of a fundamental oversight in acknowledging and understanding the role economic inequality is playing in defining housing demand and supply.

Research findings

We find a strong and consistent correlation between income inequality and house prices. The question is whether this relationship is purely coincidental. We consider how:

Inequality is pushing up prices through:

1. ***Bidding*****:** Sellers seek the most promising buyer able and willing to pay the most. If the income distribution of the pool of potential buyers widens there will be more chance for sellers to find better-paid buyers with the income to pay more. Not only would this process result in higher prices at the top it would also begin a process by which all house prices shift up.

2. ***Speculation*****:** Levels of wealth at the top have allowed the rich to increase housing speculation and hence assist the housing bubble to expand.

Inequality is directly restricting supply and in turn inflating prices by affecting:

1. ***Consumption*****:** Richer people can ‘consume’ more housing. More recently this problem has been compounded through the wealthy global elite buying prime property in central London and leaving them unoccupied. Within a supply constrained system this means that there is less to go around among others. This squeeze inevitably puts increased upward pressure on the price of housing.
2. ***Nimbyism*****:** There are increasing signs that as people become richer they become increasingly prepared to pay for restricting the construction of new homes near them.
3. ***The number of moves*****:** Increases in home prices are likely to be greeted favourably by existing homeowners as it boosts their equity. However, when homeowners seek to trade up they may well struggle to fund the move. This will increase the time between house moves and mean there are fewer homes on the market.
4. ***Sorting:*** As the rich buy into desirable areas a vicious cycle begins whereby housing markets become more sorted and the poor are obliged to seek housing elsewhere. However, the asymmetry in house price movements (stickiness) means that the uplift in rich areas is not offset by a drop in less desirable areas.

Feedback affects are further increasing the impact of economic inequality

The above mechanisms interact and feedback to create further and on-going upward pressures on house prices. Furthermore, because higher house prices lower the number of sales in the market it also affects the number of homes built. This is because private housing developers make decisions according to how much demand they see in the market. As greater economic inequality means more people being squeezed out there is less housing demand, this in turn means fewer homes built further limiting supply and again placing upward pressure on house prices.

Housing policy

Advocates of the Help to Buy scheme have argued that it will ameliorate problems of affordability and increase transactions in the housing market. We see the Help to Buy scheme as a response to inequality and falling living standards for the majority. In a nation where owning your own home is seen as a sign of progress and wealth, getting people onto the housing ladder makes political sense. However, if this policy inflates house prices it will result in a further need for credit for the next generation or in a painful correction. In London and the South East, where house prices are considerably out of line with average wages, even Help to Buy is not sufficient to help people on to the housing ladder. We must deal with the underlying issues rather than apply palliative solutions.

This research adds further weight to the need to tackle economic inequality and asks policy makers to at least acknowledge a potential relationship between inequality and the housing crisis. The housing market is complex system, if we continue to ignore the role of economic inequality we will also continue to fail in our policy prescriptions.

Introduction

Our housing stock is the biggest material asset in the UK economy.[1] However the housing market is riddled with distortions that result in housing prices out of line with median earnings and a dearth of new private and social housing. Most tend to see this simply as a supply problem – that there are just not enough suitable homes in the market. However this ignores the intermediary factors that are creating the supply side constraints. One plausible determinant that has been virtually ignored is growing economic inequality

Income and wealth inequalities have risen rapidly in the UK over the past three decades. We are now a far less equal society than we have been for generations (see Box 1).[2] As time passes the ripple effects of this polarisation are being revealed. Evidence that economic inequality lies at the heart of the financial crash, low levels of social mobility and the squeeze on the middle class has begun to permeate policy circles.[3] More recently the interest in Thomas Piketty's thesis that wealth accumulation at the top is an inevitable outcome of capitalism[4] has generated considerably discussion in the economic and policy spheres. Despite this revival in interest, it is unlikely that we have yet recognised the full impact economic inequality is having on our economy, society and environment.

This discussion paper considers income and wealth polarisation as a potential explanatory factor for the challenges we face in the housing market. The falling number of homes affordable to prospective homeowners is clearly a problem. So too are ever increasing rental costs. Waiting lists for social homes are lengthening. London in particular is suffering from a chronic housing failure. Meanwhile successive waves of policy aimed at increasing the ability of buyers to purchase homes and developers to build new homes have at best papered over and at worst further deepened the fractures.

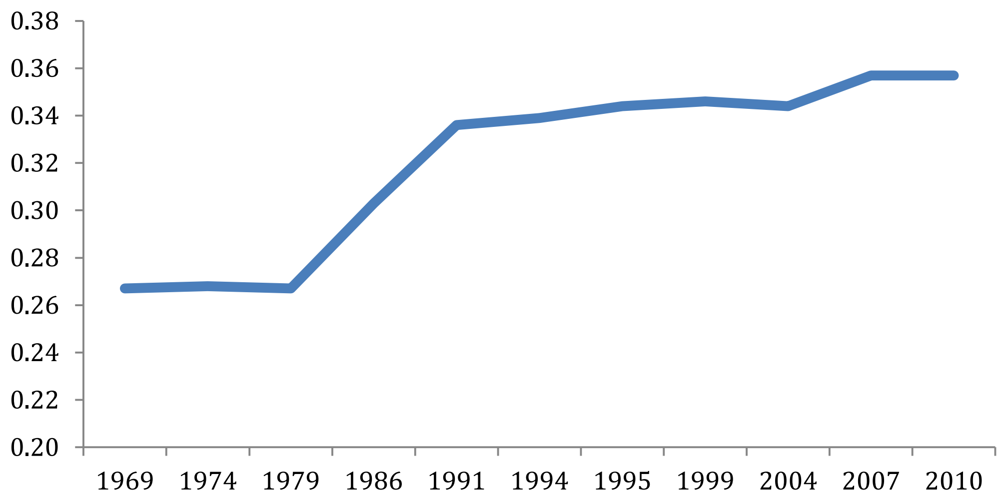
The most recent government scheme, Help to Buy mortgage guarantees, has allowed buyers to purchase a home with a deposit value of five per cent of the price with the sale backed by a government guarantee to the lender. The first phase of the scheme, launched in April 2013, was limited to new-build homes, but the second phase which begun in October 2013, has allowed buyers to use the scheme to purchase on both new and existing homes. The scheme has faced considerable criticism with several pointing out that it may further inflate prices, has unnecessarily put taxpayers at risk and will have only short-term benefits for those entering the housing market.

Help to Buy and other housing policies in the past 20 years reflects government rhetoric which assumes defects in the housing market are the consequence of rigid planning regulations, the cost of and access to mortgages, transaction costs and housing stock levels relative to the population. Economic inequality has received very little airtime. While it may be obvious that there is a connection between poverty and falling average incomes and access to housing, much less is known about how an increasing share of wealth and income concentrating at the top is driving up house prices and distorting housing supply.

Box 1: Economic inequality in the UK

It is now widely recognised that the UK has high and damaging levels of income and wealth inequalities. As Figure 1 charts, the UK saw a dramatic rise in levels of economic inequality during the 1980s, it has continued to rise since, although at a slower pace. Recent data shows that the richest one per cent of households in the UK now earn around 150 times more than the poorest one per cent of households.[5] Wealth inequality has also risen considerably, with the top 1 per cent now having more wealth than the bottom 50 per cent put together.[6]

Figure 1: UK Gini coefficient for household income 1969-2010



Source: Luxembourg Income Study.

Evidence consistently shows that higher levels of economic inequality are associated with lower social trust, social mobility, well-being, and higher violent crime rates.[7] Recent evidence has shown that a child born to a family in the bottom quarter of earners in 1970 had much less chance of ending up as a top earner by the time they were 30 (13 per cent) than a child born in 1958 (17 per cent).[8] Furthermore, contrary to neoliberal economic assertions, research increasingly shows that higher inequality can actually have a dampening effect on economic growth[9] and that it contributes to a less favourable environment for investment.[10]

There are reasons for this oversight. In a supply-constrained market you might intuitively expect increasing income disparities to increase prices at the top of the housing market and, in turn, for these inflated prices to feed through the system, locking many people out and hence quickly revealing the impact of inequality. However, the irresponsible lending that fuelled the housing boom may well have hidden the scale of the impact of economic inequality. Today it seems much clearer that access to the market is increasingly limited to the better paid and the wealthy. Help to Buy again seeks to increase access to the housing market, although even it is not enough to counter excessive levels of economic inequality in London and the South East.

This paper aims to kick off a much-needed discussion. It starts by highlighting how existing explanations for the housing market are insufficient. We then set out the relationship between economic inequality and house prices and suggest the potential mechanisms by which economic inequality might be driving up house prices. We finish the paper with a discussion of the implications of our analysis for policy and the next steps for research on this topic.

Box 2: Demand and supply in the housing market

There are many misconceptions, myths and interpretational problems about the way the housing market operates, not least the definitions of supply and demand. Supply is often regarded as the number of new homes built or the increase in the housing stock. Demand is often regarded as either the need for new homes or the number of people aspiring to buy a home. These definitions left unqualified are inappropriate.

For supply, an increase in the overall stock of homes is relevant, but needs to be judged against such factors as changes (up or down) in the overall population, migration, household size, along with the changing expectations and patterns of use such as working at home and the increased prevalence of second homes.

Meanwhile demand is often conflated with need and desire. This is somewhat ironic as it can be argued that those in most need are often those who exert least demand within the market. At the same time desire is all well and good but it only becomes effective demand if it can be funded.

For our purposes it is sensible to address simply the market for homes bought and sold in the private sector. And in relation to supply and demand we will use the definition that: **What determines activity in the house market is the number of willing and financially able buyers (demand) in relation to the number of willing sellers (supply).**

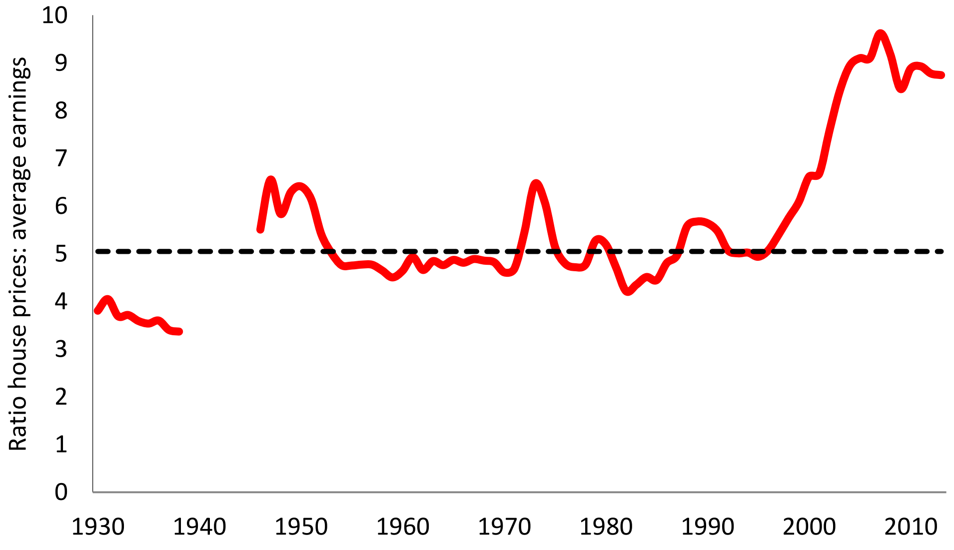
The housing challenge

Housing – the lack of and the price of – presents one of the biggest challenges for UK social and economic policy. This section briefly sets the scene for what the problems are, what policy prescriptions have been applied and how these policies have performed. We conclude that there is a need to re-examine the drivers of increasing house prices and in particular to look at the role of increasing economic inequality

House prices are out of line with average incomes

Since the mid 1990s there has been a startling decoupling of house prices from average earnings. Figure 2 illustrates the structural shift from the historic norm in the relationship of house prices to earnings in recent years. To get a long-term historic series we have used a data series that uses simple average house prices. These are not ideal and may exaggerate the peak, but most data tell a similar story. For example, a study from the Organisation for Economic Co-operation and Development (OECD) estimates that, on average, house prices are 21 per cent over priced against incomes and 31 per cent too high compared to rents.[11] Of further note, the recovery in prices we have seen since 2010 is mainly a result of rising prices in more affluent parts of the country.

Figure 2: Ratio of house prices to average earning 1930-2013

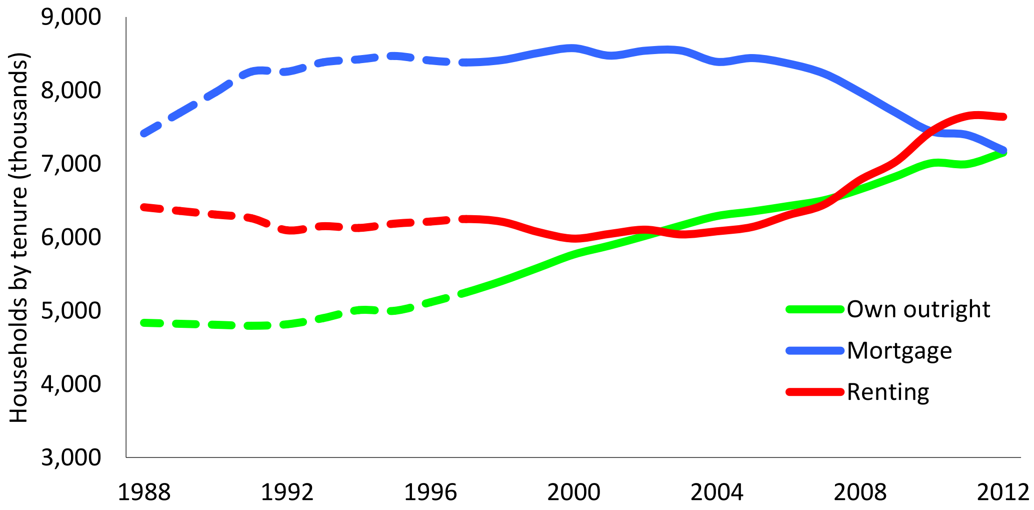


Source: Average house prices: ONS House Price Index, March 2014: Annual Tables 20 to 39, Table 22 Housing market: house prices from 1930, annual house price inflation, United Kingdom, from 1970; Earnings data Gregory Clark, "What Were the British Earnings and Prices Then?" Measuring Worth.

Increases in house prices are often seen in a positive light – a sign of a buoyant market and greater wealth for homeowners. However, all other things being equal, when prices accelerate much faster than average incomes more people are priced out of the housing market. This is especially the case when those on lower incomes are not seeing material income gains, as is the situation in the UK where median wages stagnated between 2003 and 2008 and fell thereafter.[12]

Such a situation has considerable impacts on the pattern of housing tenure. 2011 census figures show that the percentage of people living in their own homes has fallen from 68.2 per cent to 63.6 per cent while the percentage of renters has risen from 29.1 per cent to 34.3 per cent since 2001.[13] Figure 3 plots homeownership for the period 1988 to 2013. The rapid trend towards homeownership appears to falter in the 1990s. By the early 2000s we see the rental market begin to expand rapidly as fewer families enter homeownership. Today there are more people renting than are buying with a mortgage. What this aggregate data does not show is how access to the market has declined, particularly among the young.[14] Increased renting may not necessarily be a bad thing (see Box 3) but such a reversal in trends does require further consideration.

Figure 3: Trends in English household tenure (thousands of households) 1988-2013



Source: DCLG, English Housing Survey/ Survey of English Housing.

Access to credit

The popular narrative to explain the decline in home ownership is that it is due to limited and cautious mortgage lending. In response the government has introduced several new schemes, such as New Buy, Home Buy Direct and First Buy, supporting buyers of new homes by easing the financial burden on first-time buyers and increasingly on former first-time buyers (sometimes called second-steppers) who are restrained from moving as they have limited or negative equity. The current Help to

Buy scheme, which offers state guarantees for mortgages worth up to £600,000, is the latest initiative designed to extend the ability of households to enter the housing market.

While Help to Buy has enabled more first time buyers to gain a footing on the housing ladder, policies such as these may well do more harm than good because:

- Greater credit easing increases house prices and can make the housing market more volatile. The OECD estimates that financial deregulation has increased real house prices by as much as 30% in the average OECD country over 1980 to 2005.[15] The OECD point out that while more competitive mortgage markets with more diverse funding sources and lenders are likely to increase demand for housing, increase mobility and strengthen economic resilience by facilitating housing equity withdrawal they also make it easier for investors to borrow to buy homes, which may make house prices more volatile. Increases in permissible leverage (measured by the maximum loan-to-value ratio) tend to exacerbate real house price volatility in a large sample of OECD countries. Greater house price volatility in turn can decrease macroeconomic stability and income certainty for households. It can also raise systemic risks as the banking and mortgage sectors are vulnerable to fluctuations in house prices due to their exposure to the housing market.
- Given that many new entrants to the market are pricing the decisions against exceptionally low mortgage rates, the risk of a very serious correction will be increased. The effect of raising mortgages rates back to pre-crisis levels would add more than £20 billion a year in extra interest charges to the nation's mortgage bill.
- Encouraging banks to lend more in the mortgage market, such as through the Help to Buy scheme, is likely to have a short-term effect as pent up demand is satisfied. But again this short-term gain is most likely to come at the cost of the long-term as house prices rise.
- There is an obvious danger of lending beyond the means of many households – a mistake that cost the financial system and broader economy dearly since 2007.

As well as this pitfalls of extending credit, blaming bank lending practices ignores the fact that the decline in home ownership pre-dates the credit crunch and indeed started at the most extreme period of lax lending seen in modern times (see Figure 3). It seems that even high levels of credit availability cannot keep pace with the increasing gap between earnings and house prices. An alternative explanation is required.

Box 3: Home ownership: good or bad?

Much is made of the British obsession with homeownership. The truth is that homeownership is not exclusively a British obsession. It is, for instance, central to the modern notion of the American dream. In Britain around two-thirds of households are owner-occupied – this is broadly in line with most English-speaking nations. Many, but not all, northern European nations tend to lower levels of homeownership, while the southern European nations tend towards greater homeownership.[16]

The costs and benefits of home ownership are various and somewhat complex. For homebuyers a house meets two economic functions: a consumption requirement (in the form of shelter and accommodation) on the one hand, and an investment desire (towards achieving a positive return) on the other. Rising house prices have allowed homeowners to store up considerable wealth. It follows that greater levels of home ownership should help spread wealth more evenly[17] – although the extent that this happens depends on the value of interest payments on mortgages and variation in increasing housing value across the income spectrum.

Proponents of homeownership also point to the added stake that homeowners have in their community. They have a vested financial interest in improving the community and its amenities as this enhances the value of their homes.[18]

There are however costs. Homeowners tend to be less mobile.[19] This has negative implications. For instance it has been suggested that higher homeownership is positively correlated with unemployment.[20] This is because the financial costs of moving for homeowners are higher than for those in rented accommodation. Furthermore, the emotional cost of moving will be greater for homeowners as they are more likely to have built a greater sense of home.[21]

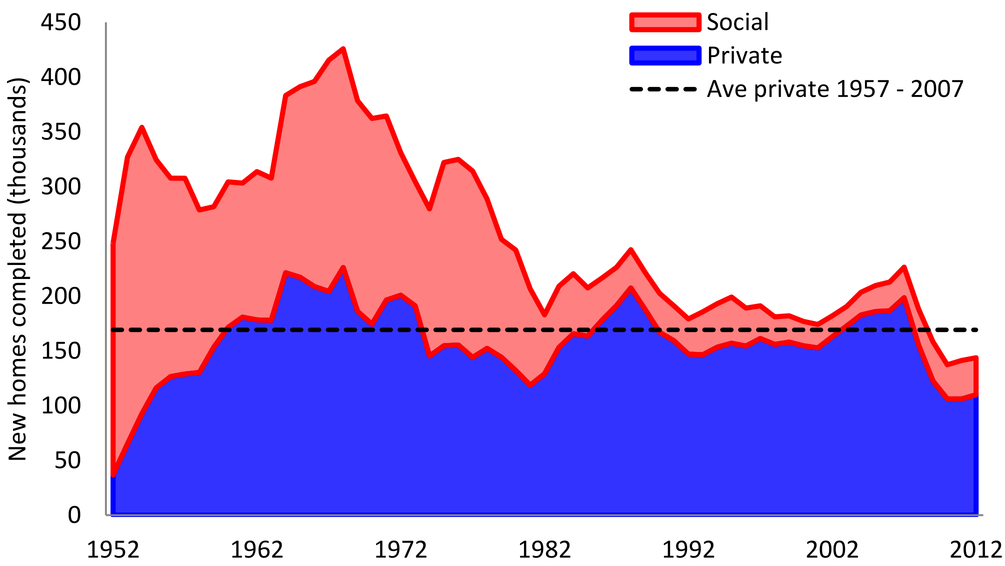
This report does not take a position on what tenure is best or consider the issue of the right split between rental and owner-occupied homes. Its purpose is instead to consider the implications of growing economic inequality for home ownership regardless of whether higher home ownership is a good or bad thing. That said the housing and rental market are highly intertwined. At the very least as rising house prices push more people into the rental sector further demands are placed on an already deeply flawed rental market.

A shortage of suitable housing

A report, *Estimating housing need*, published in November 2010[22] estimated that the number of households in need grew from 1.24 million in 1999, to 1.29 million (or 6.1 per cent of all households) in 2004. The level of need then rose sharply to 1.61 million by 2007. On the available data the team estimated that need would peak in 2009 at about 2 million households. However, this is likely to be an underestimation. Other factors, such as growing multi-family households[23] and population levels[24] indicate growing housing need.

Housing need is far outstripping house building. Currently house building in the UK remains at a historic low despite recent data showing an increase in house building starts.[25] In England, which is under the greatest stress, 109,640 new homes were completed in 2013 compared with a peak of 176,650 in 2007.[26] To meet the aspirations set by the Government in 2007[27] production would need to double.

Figure 4: New homes completed in the UK 1952-2012



Source: DCLG Live tables, Table 244: permanent dwellings completed, by tenure, England, historical calendar year series (1952-2012)

While falling affordability leaves some to conclude that there is a need for greater credit availability, falling housing completions leads many point at the planning system. Indeed, the consensus of policy has been to reduce the regulatory burden on developers through planning changes and "cutting red tape" including changes in affordable homes requirements.

There have been countless housing strategies in the past ten years focused much more on trying to incentivise house-building. For example, the Labour Government's

Homes for the future: more affordable, more sustainable[9] strategy sought to strike a deal with developers – more land for more affordable and sustainable homes. The Coalition Government's *Laying the foundations: A Housing Strategy for England,*[28] published in late 2011, focused much more on easing the burden of regulations on house builders.

As clear from Figure 4 and the discussion here such policies have clearly failed to deliver – house building remains significantly below what is needed, despite a recent increase. Part of this shortfall can be explained by the credit crunch and recession, but even before this house building was not keeping up with population growth and housing demand.

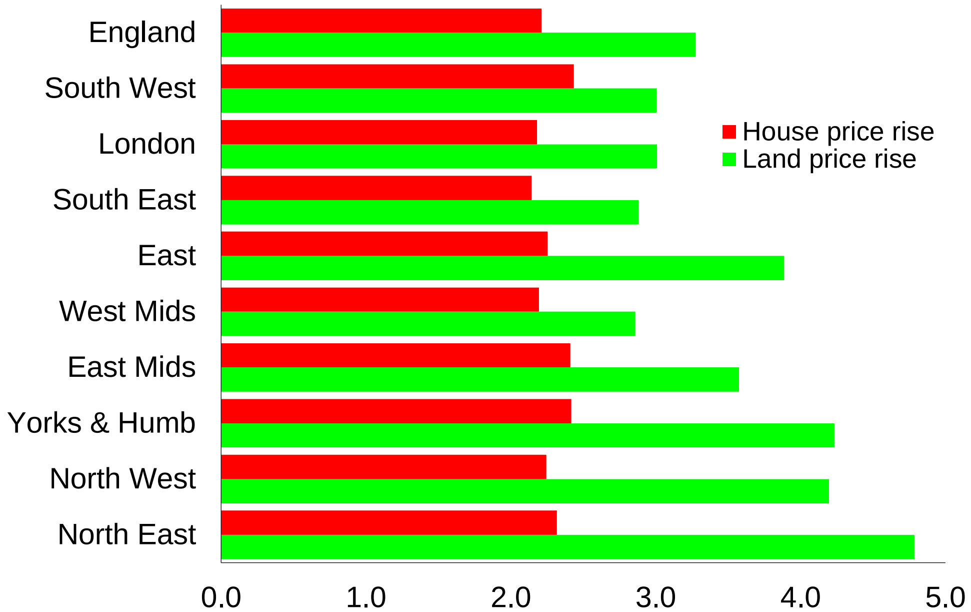
In short, lack of suitable housing is undoubtedly part of the problem, but there seems to be intermediary mechanisms or other root problems that are hindering house building and make cutting 'red-tape' and creating financial incentives for builders ineffective on their own.

Tight planning regulations

It can be argued that planning constraints, in the way they are normally articulated, cannot be an immediate problem. Current production is running greatly below the level which had been serviced by the planning system in the past. The statistics highlight that planning may not be as important as policy would suggest. In 2007 planning decisions provided for 177,000 new homes to be built in England. Planning applications, a sign of demand, fell sharply with the recession and have only recently picked up. At the time of writing they were about 20 per cent below pre-recession levels. Interestingly, an applicant is 30 per cent more likely to get an approval. This suggests it is currently easier to get approval but there are fewer applicants.[29] Again this common explanation for the housing market challenge does not suffice on its own.

Putting planning restrictions aside, it is against standard economic logic that an increase in house prices would not result in a surge in house building. The logical argument is that if house prices rise surely profits rise and hence this should draw in more competition. This may be true in the very short-run, but land values (See Figure 5) also rise when house prices rise which reduces profits (see Box 4).

Figure 5: Regional house and land prices 1999-2007



Source: ONS House Price Index, March 2014: Annual Tables 20 to 39, Table 25 Housing market: mix-adjusted house prices, by new/other dwellings, type of buyer and region, United Kingdom, from 1993; DCLG, Live tables, Table 563: average valuations of residential building land with outline planning permission (final version) (discontinued).

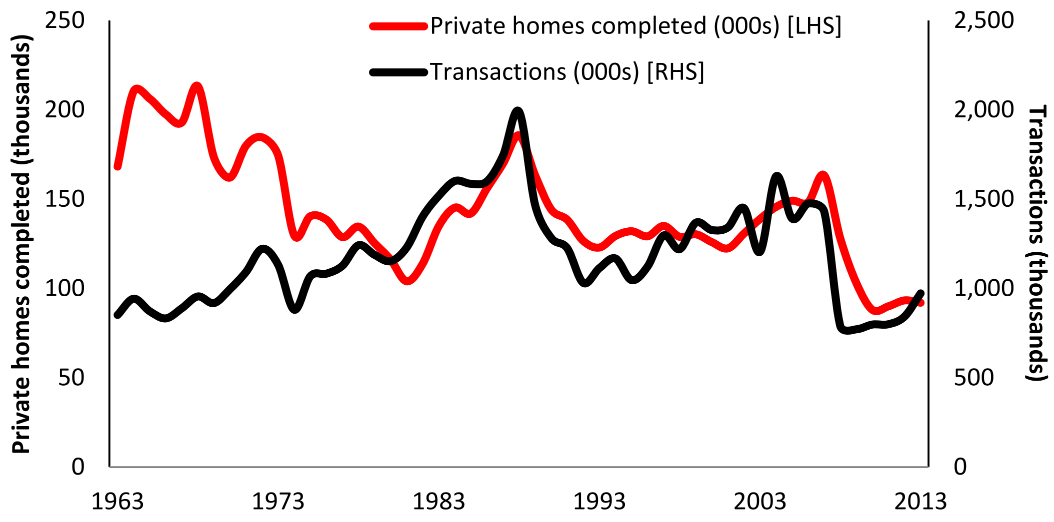
This rise also means fewer people are able to buy. This is important because house builders, like all sellers of homes, determine the asking and sale price by reference to the price houses are currently fetching in the local market. If prices are high but demand has fallen because of fewer people able to buy, house builders will not be incentivised to build.

Figure 6 shows that since the 1970s there has been a very close link between the number of homes built and the number of housing transactions in the market. This has led to an approximately stable one to ten ratio of new homes sales to total home sales in the market.[30] Even after shocks in the market, such as the collapses after 1988 and 2007, the delivery of new homes has adjusted smartly downward in line with overall sales, with the lags suggesting the pattern of new build sales follows the wider market.

The relationship since the 1970s[31] seems too close for pure coincidence. It is more than likely that house builders are responding to the number of homes sold in the market.

The key to increasing production of new homes in the private sector appears to be the level of transactions. However, higher prices have squeezed out potential buyers resulting in fewer sales, and hence fewer homes on the market. One could argue that a scheme like the second phase of Help to Buy would assist with this by increasing transactions in the market place. However, as recent data shows, this scheme is not increasing transactions in areas where demand is greatest for housing is greatest.[32] Even with government help, many cannot afford to buy in London and the South East.

Figure 6: Private completions and residential transactions in England and Wales 1963-2013



Sources: Private homes data: DCLG, Table 245: permanent dwellings completed, by tenure, Wales, historical calendar year series, Table 244: permanent dwellings completed, by tenure, England, historical calendar year series. Transactions data: HMRC, Economic Trends Annual Supplement 2006 (table 5.5) 1959 to 2005 property transactions, HMRC, Annual Transactions, 2006 to 2012. Authors adjustments.

Summary

There are both demand and supply challenges, but the story is more complicated than current discussion and policy prescriptions convey. Blunt tools aimed at increasing supply or credit to boost demand have failed to halt the housing crisis and have indeed made the situation worse.

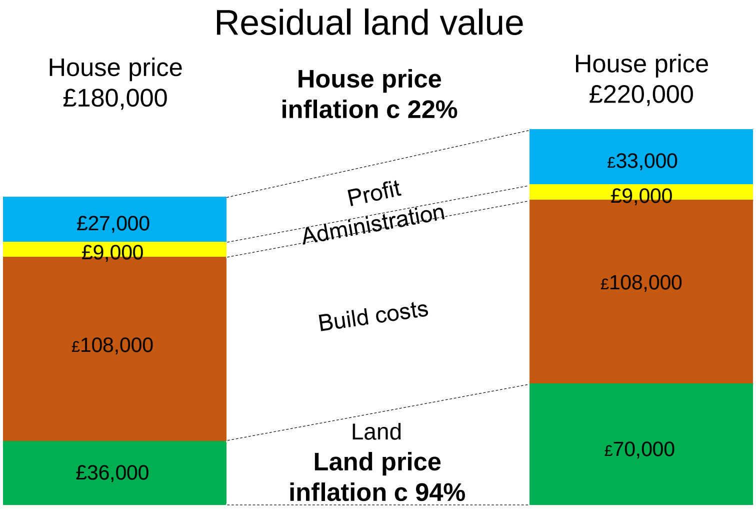
Improvements to the planning system and policies that secure a more sustainable and equality-enhancing financing system are much needed. However, we believe that a much more fundamental examination of housing policy is needed that looks beyond the obvious solution. This means re-examining the drivers of increasing house prices. Part of this examination in our view should be to explore the effects on the UK housing system of wealth and income inequality.

Box 4: Residual Land Value

Figure 7 explains the residual land value model which is used by house builders and developers when buying land. Assume a house is being built on a standard plot. If its market price is £180,000 with the builder wishing to take 15% margin (£27,000) on a build cost of £108,000 which will attract £9,000 of administration costs. This will leave builder willing to pay £36,000 for the land.

Now assume market prices rise and the target price for the same house on the same plot of land is £220,000. The 15 per cent margin will be £33,000, the build cost and administration costs will remain broadly the same at £108,000 and £9,000. This will leave builder willing to pay £70,000 for the land.

Figure 7: Residual land value



Under the residual land value model the land value will always be derived from current house prices. This process is why we see land value prices rise far faster than house prices.

Current house prices will, all other things being equal, determine the demand for all homes. This will in turn determine the number of new homes built. The likely rate of build will in turn determine how much land is bought and used for house building.

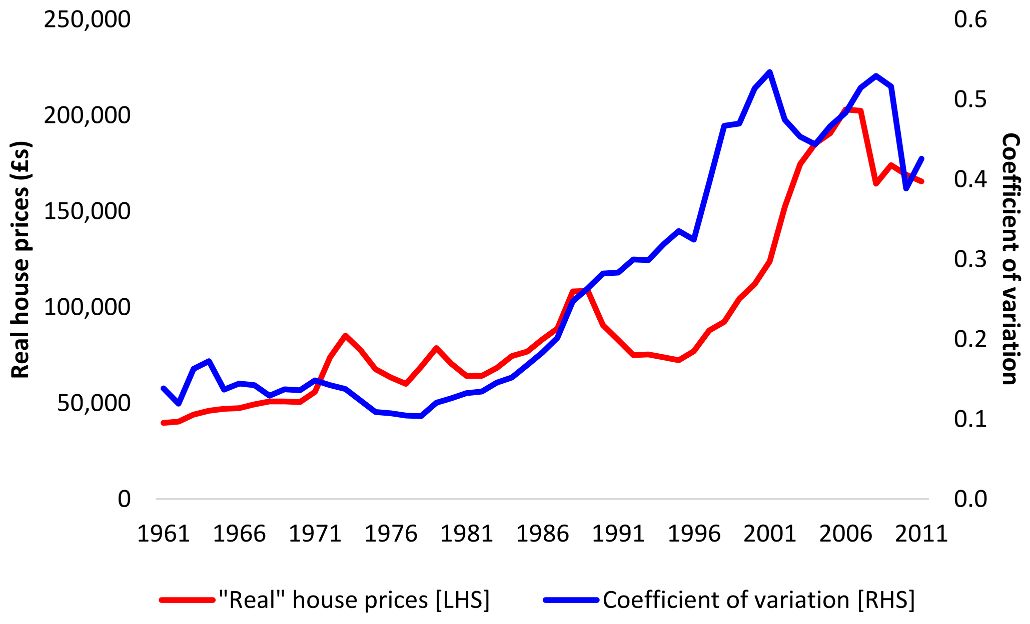
The relationship between economic inequality and house prices

During the past three decades we have witnessed both a dramatic increase in income and wealth inequality and a stark rise in house prices. This section considers the strength of this correlation as well as the causal mechanisms that may be driving this relationship.

The correlation between income inequality and rising house prices

If we look at the relationship between income inequality, as measured by the coefficient of variation in household incomes before housing costs, and real house prices we see a very strong correlation. Figure 8 plots both real house prices and income inequality. Even without adjusting for a likely lag effect we find a correlation of greater than 0.8. When we introduce a lag of six years between income inequality and the house prices the correlation strengthen to more than 0.9.

Figure 8: The correlation between income inequality[33] and real house prices for the UK



Source: Nationwide average house price deflated using HMRC Treasury GDP deflators. Inequality: IInstitute of Fiscal Studies. (2013). Living Standards, Poverty and Inequality in the UK.

Naturally correlation does not mean causation and there are likely to be several factors that have pushed up house prices in recent years. In addition there are always imperfections in data. However, there is international evidence to support this point. For example a studies of US cities suggest that income inequality in tight markets does result in increased house prices[34] and that the poor became more crowded in their homes despite spending more.[35] The correlations above demonstrate that such processes may well be playing out in the UK where there is clearly a tight supply of housing. We have not plotted the relationship between rising wealth inequality and house prices but we know that there is again a strong correlation. What must be considered now are the mechanisms by which this transfer from economic inequality to house prices is taken place.

How economic inequality is causing house prices to increase

The housing market involves a complex set of interactions. Deciphering the exact role of any one factor, such as inequality, is difficult. We draw on supporting data, academic literature to outline the plausible routes of causality. The mechanisms we uncover are in many ways related and potentially act together to strengthen the impact of rising income and wealth inequalities on house prices.

The plausible mechanisms through which growing economic inequality may be directly increasing house prices include:

Bidding

The most obvious mechanism through which economic inequality might push prices up would be through the bidding process that lies behind house purchases. Sellers do not accept the average price but seek the most promising buyer able and willing to pay most. In a supply-constrained market, such as in the UK, there will be increased pressure on prospective buyers to push up their bids. If the income and wealth distribution of the pool of potential buyers widens there will be more chance for sellers to find better-paid and wealthier buyers with the resources to pay more.

Not only would this process of bidding in the context of large income and wealth disparities result in higher prices at the top it would also begin a process by which all house prices shift up, because at each level there is likely to be a wider distribution of incomes and wealth among the buyers.

A study in the US found that in places that are desirable but have low rates of new housing construction, families with high incomes or strong preferences for that location outbid lower willingness-to-pay families for scarce housing, driving up the price of both housing in the area and the underlying land. As the number of high income families grows nationally, existing residents are outbid by even higher-income families, raising the price of land yet further. By contrast, in municipalities where construction is easier, any family who wishes to live there – rich or poor – can buy in at the cost of constructing a new house and, instead of growth in house prices, the area exhibits growth in the quantity of houses. Land prices act as a clearing mechanism, so lower-income households are disproportionately excluded from cities that have limited supply, leaving behind concentrations of higher-income households. The overall result is a changing composition of residents toward higher income families. This is perhaps one of the reasons that the poor are increasing shifted out of the city and into the suburbs of UK cities.[36]

Living in a popular part of a city is affectively like owning a scarce luxury good. [37] The former head of the Financial Services Authority, Adair Turner, has suggested that growing income and wealth concentration has allowed a small group to funnel extra funds into living exactly where they want to live, setting a much higher house price bar.[38]

Speculation

Speculation in the housing market is commonplace, driven by the recognition that large amounts of money can be made with little effort. Access to finance and the interest rate are critical to being able to speculate. The greater the speculation the more bubbles are allowed to expand.

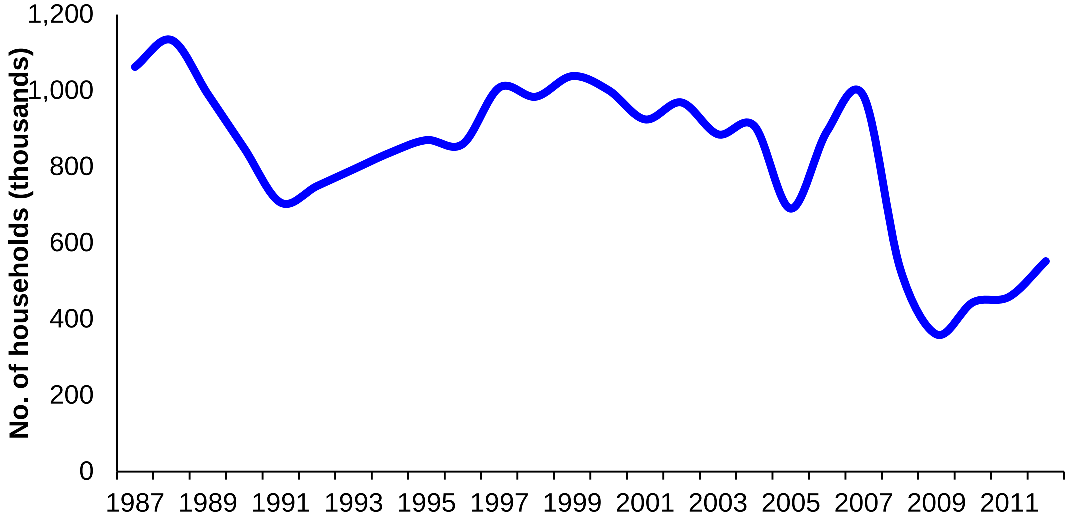
There is evidence to suggest that where cities experience higher than average rent growth there will be a willingness to pay a greater multiple of current rents to obtain a house. This is rational given the higher expected growth in earnings for these properties.[39] This is a further reason for speculators to pay more.

Lowering the number of movers

If income distribution becomes reflected in the distribution of house prices and also acts to push up prices, this will be greeted favourably by existing homeowners as it boosts their equity. However, when homeowners seek to trade up they may struggle to fund the move.

Circumstances will vary but looked at across the income spectrum there is likely to be an increase in the time between the moves made by households. The increase in the time taken for newer homeowners to trade up is now well recognised.[40] Figure 9 shows that the number of moves made by homeowners is dropping so the average time between moves has risen. This reduced turnover rate means fewer housing transactions. And, as we have discussed, fewer transactions appear to mean fewer new homes built, reducing potential supply and pushing up prices.

Figure 9: Owner occupiers who have moved in past year 1987-2012



Source: DCLG, English Housing Survey Headline tables 2012 & 2013. Survey of English Housing, Table S211: Trends in current tenure of moving households 1984 to 2007/08. Authors adjustments.

Increasing housing consumption at the top

An increase in the numbers of richer people will allow this group to 'consume' more housing. For instance, the number of second homes in England grew by about 30 per cent in the decade leading up to 2008.[41] This compares with a rise of less than 7 per cent in the total stock.

The figures for second homes are relatively small in relation to the overall stock. But this data tends to support the view that the distribution of housing has become less even and that consumption of housing by the better off has increased. This might include not just second homes but larger houses. This in itself need not be a problem, if the supply increases to adjust. But within a supply constrained system it means that there is less to go around among others. This squeeze inevitably puts increased upward pressure on the price of housing.

Further pressure, this time from international buyers, has been placed on the London housing market because it is seen as a safe haven for foreign money. The global rich, including those in countries such as Greece and Cyprus which have seen austerity measures include wealth taxes, are keen to deposit their wealth in London housing because of raising prices.[42] Reports of prime London property being bought and left empty are now commonplace and commentators have rightly pointed out that this phenomenon is not only contributing to a speculate bubble but also to parts of the city left empty, undermining the vibrancy of the city.[43] For example, the very the wealthy London borough of Kensington and Chelsea saw a fall in the population between 2001 and 2011 while all other boroughs saw their population increase as London's housing stretched to accommodated a further one million people.

Encouraging nimbyism

Both in the UK and abroad ever more interest is being taken in *nimbyism*. Academics are finding increasing evidence that growth in income among homeowners has led them to become increasingly resistant to seeing new homes built near them. For example authors of a paper for the US National Bureau of Economic Research note: "…most existing superstar cities could expand supply by increasing density, but choose not to. The political economy behind that decision is only just beginning to be studied."[44]

The suggestion is that as people become richer they become increasingly prepared to pay for restricting the construction of new homes near them. A DCLG report *Public attitudes to housing in England* found that 28 per cent supported more homes being built in the local area against 46 per cent opposed. The support was much higher among renters (about 47 per cent) than for homeowners (about 23 per cent).[45]

The ripple affects of growing economic inequality in the housing market

Increasing income polarisation has resulted in increasing socio-economic sorting into neighbourhoods[46] which in turn leads to an increase in the distribution of house prices between areas. A vicious cycle begins whereby housing markets become more sorted as the rich buy into more desirable areas and the poor are obliged to seek housing elsewhere. Richer neighbourhoods become like luxury goods – people are willing to pay over the odds to live because of status. However, the asymmetry in house price movements (stickiness) suggests that the uplift in rich areas is not offset by a drop in less desirable areas, at least not in the short to medium term. One study has found the house prices could fall for the poorest but only if government does not intervene to increase the supply of credit.[47]

Where these desirable locations correspond with places of employment those on lower incomes with jobs in the area face the choice of paying more to live by their workplace or accept a longer commute with its attendant costs. Those that can choose to pay a premium in the form of higher house prices to save time and travel costs.

The effects of this process are evident in London. The sorting effect has excluded people employed in the capital from living near to work, and has introduced into the housing lexicon 'keyworker' housing – affordable housing for 'essential' workers who are otherwise priced out of the local market.

There are a number of plausible mechanisms by which economic inequality might restrict both the demand for and supply of housing resulting in upward pressure on house prices. But there is an extra level of force being created through feedback and ripple affects.

The richer desirable enclaves become the more they attract desirable amenities. This further increases the appeal of the neighbourhood. This leads to sellers demanding higher prices, which then leads to more potential homebuyers being priced out.

Similarly nimbyism feeds on itself in a perverse reversal of the tragedy of the commons. Restricting access raises the value of homes for those already living in the area. It ensures that new entrants to the area are richer and therefore, theoretically, more able to sustain the cost of better amenities. This in turn raises the value of homes in the area.

Furthermore the housing market allows beneficiaries of economic inequality to crystallise their income and wealth advantage into increasing amounts of wealth, creating greater wealth inequality (see Box 1). This in turn affords them the opportunity to buy into the market at higher prices than they would otherwise have been able to. This once again provides upward pressure on house prices and acts to exclude increasing numbers of the less well paid and less wealthy from the market.

The relative importance of economic inequality

We have established that there are a number of plausible mechanisms by which income and wealth inequality might support high house prices. However, many will argue that while this may be potentially interesting, other factors are much more important, such as planning regulations restricting supply or unsustainable lending by banks creating a housing bubble.

We are not arguing that these factors are unimportant, but that economic inequality must be considered alongside them. It is also worth noting that these two features of the housing market are not entirely divorced from the issue of economic inequality.

In a discussion paper for the Bank of England's External MPC Unit[48], David Miles states: *"…high population density, high real land prices, high real house prices, high house prices relative to incomes and a low elasticity of housing supply. It might be argued that these phenomena are a reflection of UK planning rules rather than underlying economic forces. But I find that unconvincing, or at least superficial. It treats planning rules as an exogenous factor. But planning rules reflect the underlying economic forces."* In others words, local levels of wealth can affect planning decisions, see point on nimbyism in Section 3.2.

It is legitimate to argue that house prices have been fuelled by debt. However, policies to increase credit availability are argued to have been purposely employed in the 30 years leading up to the financial crash in order to ensure that those in low-middle income households were able to 'keep up with the Jones''.[49] In addition, increased speculation which is directly related to the housing bubble has been spurred on by mounting wealth at the top at a global level.[50]

Finally, it is worth noting that were income levels more evenly distributed aggressive rises in house prices would price out larger groups of prospective buyers far more rapidly and in all likelihood provide a stronger counter to further price inflation. It is hard to imagine a world with much greater income equality where growing house prices could be anything other than unstable and short-lived.

Discussion

The housing market is dysfunctional – housing need is increasing and house building is at a historic low. This we know. The causes and solutions are much debated. But the housing market is a complex make-up of heterogeneous local markets, each influenced by differing and often conflicting factors at different points in time. This makes it troublesome to isolate and confidently say what is influencing change. But within the analysis, solution seeking and debate over housing policy we believe one crucial factor is infrequently mentioned and inadequately considered, that is economic inequality.

This discussion paper has highlighted the high levels of correlation between income inequality and house prices. It has also considered the causal root by which this relationship holds and has further explored how income and wealth inequality is affecting the number of homes built. Because of the complexity of circumstances and influences on the how homes are built and traded we have deliberately restricted our scope and kept our arguments relatively simple and confined to the private sector market.

We do not statistically prove that economic inequality is a causal factor that has led to housing crisis, and believe that even if it is then it will not and cannot be the only reason housing policy in the UK is failing. But our central aim was to explore the impact of economic inequality on the private housing market and assess whether it deserves greater prominence in the debate. The evidence illustrated here highly suggests that it does.

Summary of findings

We have considered the various ways that economic inequality acts to squeeze out buyers from the market, reduce effective demand and restrict the number of homes built. The thread of the argument is that:

1. Rising economic inequality is a vehicle for increasing and maintaining higher house prices in the UK. This occurs because of a number of mechanisms, including bidding, sorting and nimbyism. The tight supply of housing is particularly important for explaining why economic inequality translates in to higher house prices in the UK context.
2. While initially the effect of rising prices on those who currently own homes may seem favourable, in reality it makes it harder for them to move and trade up. It also makes it more difficult for first time buyers to enter the housing market.
3. As a result we are seeing fewer people entering the housing market and fewer able to move.

4. This inevitably bears down on the number of housing transactions and in turn the number of homes built. This then constrains supply further exacerbating the problem.

This paper has only begun to unpick each of these processes. What is needed now is more in-depth academic and policy research on the topic.

Implications for economic inequality and society

Residential property represents the majority of the nation's wealth, so unequal access to homeownership crystallises into greater inequalities in wealth. The Human City Institute (HCI) has illustrated the extent to which inequality is embedded in tenure patterns in the UK. They find that while home-owners have an average of £100,000 in equity, social housing tenants have £1,000 in savings on average and two fifths have no assets at all.[51]

There is also a growing problem of intergenerational wealth divides, with housing wealth concentrated in the hands of the older generations. 2010-12 ONS figures show that those aged 54-64 had almost six times more wealth than those aged 25-34.[52] One study found that the debt that has accumulated among younger people almost mirrors the housing wealth that has been gained by the older generation.[53] Such a transfer in wealth between generations may not be such a problem if the wealth is transferred back through inheritance, but those who will gain most will be those already wealthy, further driving wealth inequality.

Society as a whole risks greater spatial segregation and the social tensions this polarisation brings with it. NEF's research in the London borough of Islington brought these tensions to life, highlighting the wide gulf in the everyday lives and future prospects of Islington residents and underlying distrust between socio-economic groups. The housing market in the area is playing a key role in forcing out the 'bridging' middle-income families.[54] This is a story that is playing out in other central London boroughs – leaving only those poor who live in the dwindling social housing sector and the wealthy whom are able to afford the private housing sector.

Those living in poor housing conditions are at risk to poorer health, educational outcomes and fewer economic opportunities. In 2010 Ecorys[55] produced various costs associated with the social impact of poor housing. The study put the added cost to the police of responding to crimes related to poor housing at £1.8 billion a year. It suggested the cost of lost earnings to the current generation was £14.8 billion. And it assessed the costs associated with poor health at £2.5 billion a year.[56] The negative outcomes perpetuated by the dysfunctional housing market are too expensive to ignore.

Policy implications

The aim of this paper is to kick-off the discussion on the role of economic inequality in the housing market. It is outside the scope of this report to consider specific measures to tackle inequality and the housing crisis. However, if economic inequality is indeed playing a role in the housing crisis there are considerable implications for policy.

Ultimately, if our analysis holds, the whole notion of a home-owning democracy appears to rest on reducing inequality. Current projections show that inequality is likely to increase[57] – with potential implications for not only our housing market, but also society and the wider economy.[58] As a starting point we believe that further and significant research should be undertaken to examine more systematically the influence of economic inequality in working of the UK housing market.

Our findings suggest that existing policies, which are mainly aimed at reducing the regulatory burden and at stimulating the private market through inducements and guarantees, may have short-term impacts but there is a danger that some of these policies may exacerbate the entrenched problems in the long-term. Ultimately, current policy ignores the fundamental challenges in deriving a more inclusive and robust housing market. The rewards from addressing the root causes of the housing market crisis, which potentially lies within growing economic inequality, would not only put the housing market on a more sustainable and stable footing but would mean we address a problem that is resulting in a number of other damaging economic and social outcomes. Furthermore, given that housing wealth is key driver of growing wealth inequality tackling the housing market crisis will have positive feedback affects on overall levels of inequality.

Like all difficult challenges, a more sustainable approach to addressing the housing market challenge will take time to yield results. However, given the protracted nature of the housing crisis it is vital that we reconsider the nature of the housing market challenge and adjust policy levers to fit the task.

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