

# **Do measures that discourage buy-to-let investment increase rents?**

## **A Generation Rent paper**

By Dan Wilson Craw

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### **Summary**

The private rented sector has doubled in size in the past 15 years. With the traditional route to owner occupation out of reach for millions of people and one in four children now living in a privately rented home, the government is facing demands to make the tenure more fit for longer term living. A central reform around which there is a growing consensus is the need to improve security of tenure.

The ability of a landlord to evict a tenant without needing a reason is enshrined in Section 21 of the Housing Act 1988. Such flexibility has helped to drive the popularity of residential property among amateur investors.

Any substantial improvement in security of tenure would involve restricting Section 21, as the government has proposed in its three-year tenancy, or abolishing it, as Generation Rent and others have advocated. The central objection to this often raised within the industry is that less freedom for landlords will cause many to leave the market, and that in turn this lower supply of private rented properties will result in higher rents for tenants. Similar arguments continue to be made in relation to recent tax measures aimed at landlords.

In this paper we will demonstrate why there is no reason to believe measures that cause the private rented sector to shrink will push rents higher. This line of reasoning is based on a misperception of how the housing market operates. Market rent levels are set by the balance of supply and demand across all tenures, which are intimately connected. Since the market for new lets is competitive, landlords affected by the tax changes have no pricing power to pass on costs to tenants. Meanwhile landlords seeking to exit the sector have to sell – either directly or indirectly via a chain of home movers – to another landlord or a first-time buyer. In the former case the size of the private rented sector remains unchanged. In the latter, the reduction in the supply of rented houses is matched by a corresponding fall in the demand for private rentals. The balance of supply and demand in the rented sector, and hence rent, therefore remains unchanged.

The available empirical evidence also offers no support for the idea that fewer landlords will mean higher rents. We have seen two moments in the past decade when external events have acted to change either the demand for, or supply of, rented housing. First, in 2008, mortgage lenders withdrew high loan-to-value mortgages as a result of the credit crunch, increasing demand for

private rented properties as deposit requirements jumped and first-time-buyer numbers collapsed. Then, in 2016, the government started introducing tax changes for landlords designed to reduce the supply of private rented properties.

Theory would not suggest any particular shift in level of rent as a result of these specific developments (although other associated events such as the recession in 2008-09 would be expected to have an effect). But by the property industry's line of reasoning we should expect to see rents jump in each case as the supply and demand of rented properties was pushed out of balance.

In both instances however, rent levels did not behave in this way. Despite increased demand after 2008, inflation-adjusted rent fell by 6.7% in the three years to January 2011. A drop in loans for landlord purchases after the 2016 tax change was associated with a slight shrinking of the private rented sector, but since that point rents have again been falling in real terms. Comparing trends in rent and household income levels, similarly, offers no support for this line of reasoning.

**Consequently, while they would raise home ownership rates, there is no theoretical or empirical backing for the claim that measures that reduce the supply of private rented properties will push up rents. The size of the private rented sector should not therefore distract the government as it designs a fairer system of private tenancies.**

The paper also considers the impact of improved security of tenure on investment in new supply. A view attributed to the Treasury is that mandatory longer tenancies would “scare off investment in property development”. This could mean several things, including new homes being built for rent, landlords buying new homes, and landlords investing in existing properties. With a sustained fall in new supply relative to demand, rents would rise. But only a small proportion of new stock ends up in the rental market, and much of it is let by landlords who value long-term tenants – particularly institutions that offer better terms than the government is proposing. There is therefore no reason to expect overall supply to fall relative to demand as a result of better security of tenure.

## **Recent and proposed measures that discourage buy-to-let investment**

There have been a number of measures taken by recent governments that make life harder for landlords in terms of their tax treatment: partial withdrawal of mortgage interest relief, additional stamp duty on buy-to-let homes, and restrictions on wear-and-tear deductions. These are expected to diminish the financial attractiveness of buy-to-let investment and may therefore induce some landlords to relinquish their lettings portfolios, while deterring would-be landlords from entering the market.

Some members of the property industry reacted to these measures by claiming that the withdrawal of mortgage interest relief would lead some landlords to exit the market. A 2017 study by AXA claimed that almost half of landlords planned to quit the rental market by 2020.<sup>1</sup> Others predicted that the stamp duty surcharge would see a fall in landlords buying rental properties. This is all understandable and we might therefore expect to see a decline in the size of the private rented sector as a result.

Other commentators have gone further to suggest that this lower supply of private rented homes would result in higher rents. Simon Rubinsohn, Chief Economist at RICS, said in July 2018, “While it is understandable that the government wanted to provide a lift for first time buyers, this may well come at the cost of higher rents as the appeal of buy to let diminishes.”<sup>2</sup>

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<sup>1</sup> <https://www.axa.co.uk/Newsroom/Media-Releases/2017/Landlords-feel-unfairly-targeted-by-tax-changes/>

<sup>2</sup> <https://www.independent.co.uk/news/business/news/uk-property-market-decline-house-prices-zoopla-rics-sales-drop-a8444436.html>

David Cox, the managing director of the Association of Residential Letting Agents, even suggested that landlords would be able to charge a higher rent simply because they had paid more to add to their property portfolio, telling the BBC in October 2016, "Tenants will be hurt most, as landlords recover the stamp duty increase by charging tenants more".<sup>3</sup>

More recently the government has proposed longer tenancies (Table 1). The reaction from industry groups has been muted but, similar to the claims highlighted above regarding the tax measures, it has been suggested that such measures will deter landlords and hence increase rents. During a Commons debate in April 2016, then Housing Minister Brandon Lewis said, "We believe that more restrictive and excessive legislation, such as forcing longer tenancies or notice periods, would mean that fewer homes were available in the market to rent. That would not help landlords or tenants."

Table 1: Proposals for improved security of tenure

Aspect of tenancy	Ministry of Housing, Communities and Local Government <sup>4</sup>	Generation Rent <sup>5</sup>
Length	Three years	Indefinite
Flexibility for tenant	Three months' notice after 6 months	One month's notice to move out
Flexibility for landlord	Can evict at 6 month point, or if can prove Section 8 grounds (including sale)	Can evict if can prove Section 8 grounds (including sale)
Protection for tenant not at fault	"Encouraging" landlords to sell with tenants in place	Landlord months' rent if tenant is evicted without fault
Protection for landlords with tenants in arrears	Reforms to housing court processes	Government-backed insurance system
Limits on rent rises	To be agreed by parties at the start of the tenancy	Limited to wage growth

The idea that policies designed to discourage buy-to-let borrowing, favour first-time buyers and place new obligations on landlords would cause the size of the private rented sector to shrink is uncontroversial.

**But to suggest that this will lead to higher rents is based on the misconception that rents are determined by levels of supply and demand in the private rented sector alone rather than, as is actually the case, levels of supply and demand in the housing market as a whole.**

### Does economic theory suggest that rents will rise?

The market for new lets is a competitive one, which means that landlords are constrained in what they can charge new tenants. What determines the market rent on a given house is the overall

<sup>3</sup> <https://www.bbc.co.uk/news/business-37547912>

<sup>4</sup> <https://www.gov.uk/government/consultations/overcoming-the-barriers-to-longer-tenancies-in-the-private-rented-sector>

<sup>5</sup> Consultation response available at: [https://d3n8a8pro7vnm.cloudfront.net/npto/pages/6540/attachments/original/1536938358/Longer\\_tenancies\\_consultation\\_response\\_GR.pdf?1536938358](https://d3n8a8pro7vnm.cloudfront.net/npto/pages/6540/attachments/original/1536938358/Longer_tenancies_consultation_response_GR.pdf?1536938358)

balance of the effective demand for housing (simply, the number of households and their ability and willingness to pay for housing) and the supply of homes – across all tenures.

In other words, the relative size of the private rented or owner occupied sectors has no direct bearing on the prevailing rent. Consequently landlords exiting the sector by selling their properties will not affect market rents.

The reason for this is that the supply of and demand for the private rented sector and that for owner occupied houses are intimately connected. Houses are either owner occupied or rented, so if landlords trying to sell do not sell to another landlord, they have to sell to an owner occupier. That household will either be a first-time buyer, or an existing owner occupier moving house and involved in a chain that ends either with a landlord or a first-time buyer.

The net effect is that the total number of properties in the PRS can only fall by landlords selling (directly or indirectly) to first-time buyers, who will by and large be renters. **As landlords exit the market they therefore cause a reduction in the supply of private rentals that is matched by a corresponding fall in the demand for private rentals. The balance of supply and demand in the rented sector, and hence rent, therefore remains unchanged (Figure 1).**

What about the argument that landlords will be able to pass on the cost of fiscal measures to their tenants? This is highly unlikely. **In a competitive market, the economic incidence of the tax measures will tend to fall on the landlords since those that try to raise their rent will find themselves undercut by other landlords unaffected by the measures.** The government estimates that one in five landlords are affected by the mortgage interest relief changes, while an even smaller proportion will have paid the stamp duty surcharge. Similarly, the burden of not being able to evict tenants without grounds will fall on the minority of landlords for whom retaliatory eviction and churn is part of their business model. If they raise rents to compensate, they will be undercut by the majority, who value long-term tenants and would be unaffected by higher minimum standards. Looked at another way, if those landlords had the pricing power to charge higher rents, it's unclear why they wouldn't have exercised that power before the tax measures took effect.

Consequently there is no strong theoretical reason to anticipate either that landlords will be able to pass on their higher costs to tenants or that an exodus of landlords, due either to tax or regulatory measures, will raise rents. But what do the data show?

## **What happened to rents in the wake of past shocks to the PRS?**

We can test this theory against events in the housing market that have affected the size of the private rented sector over the past 13 years, and identify what relationship, if any, there is between external shocks to the supply of or demand for rented housing and rents. The logical extension of the ARLA and RICS arguments is that any external shock that either pushes up demand for renting or pushes down the supply of rented properties will raise rents. If true, this should be evident in the data on rent around the time of such events.

The Office for National Statistics publishes a monthly Index of Private Housing Rental Prices (IPHRP) dating back to 2005.<sup>6</sup> This looks at all private sector tenancies, as opposed just to new tenancies, and draws data from the Valuation Office Agency which is then adjusted to make sure it is not influenced

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<sup>6</sup> Office for National Statistics, Index of Private Housing Rental Prices series, <https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/indexofprivatehousingrentalprices/previousReleases>

Figure 1: Landlords leaving the market have no impact on overall supply

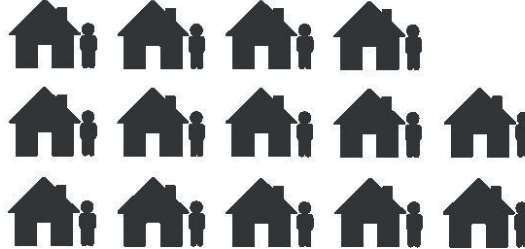
## Before

### Private rented sector



There are around **5m** private rented homes in England, housing around 5m households.

### Owner-occupied sector



There are **14m** owner-occupied homes.

### What would happen if tenancy reforms caused some landlords to sell up?

Let's say the private rented sector shrinks by **1 million** homes.



Those homes do not just disappear: if they are not sold to other landlords, they must be sold to owner-occupiers.



While the supply of rented homes shrinks, the missing **1m** homes are now owner-occupied...



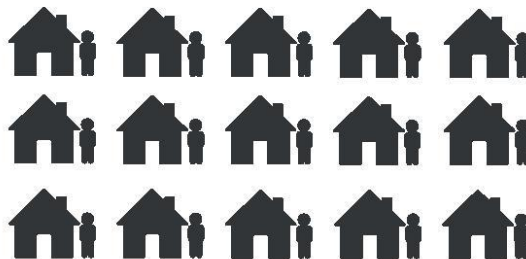
...which means that there are **1m** more households in owner-occupation, who are no longer demanding rented homes.

## After

### Private rented sector



### Owner-occupied sector



Following this transition there would be **4 million** private rented homes housing **4 million** households and **15 million** owner occupied homes. Supply still balances demand so there is no impact on rents.

by changes in the composition of the private rented sector. We have used the figures for Great Britain and adjusted these for inflation to understand the evolution of rent levels in relation to overall consumer prices.<sup>7</sup> To track the size of the private rented sector, we use the Labour Force Survey household datasets, since they are more timely and frequent than the English Housing Survey measure.<sup>8</sup>

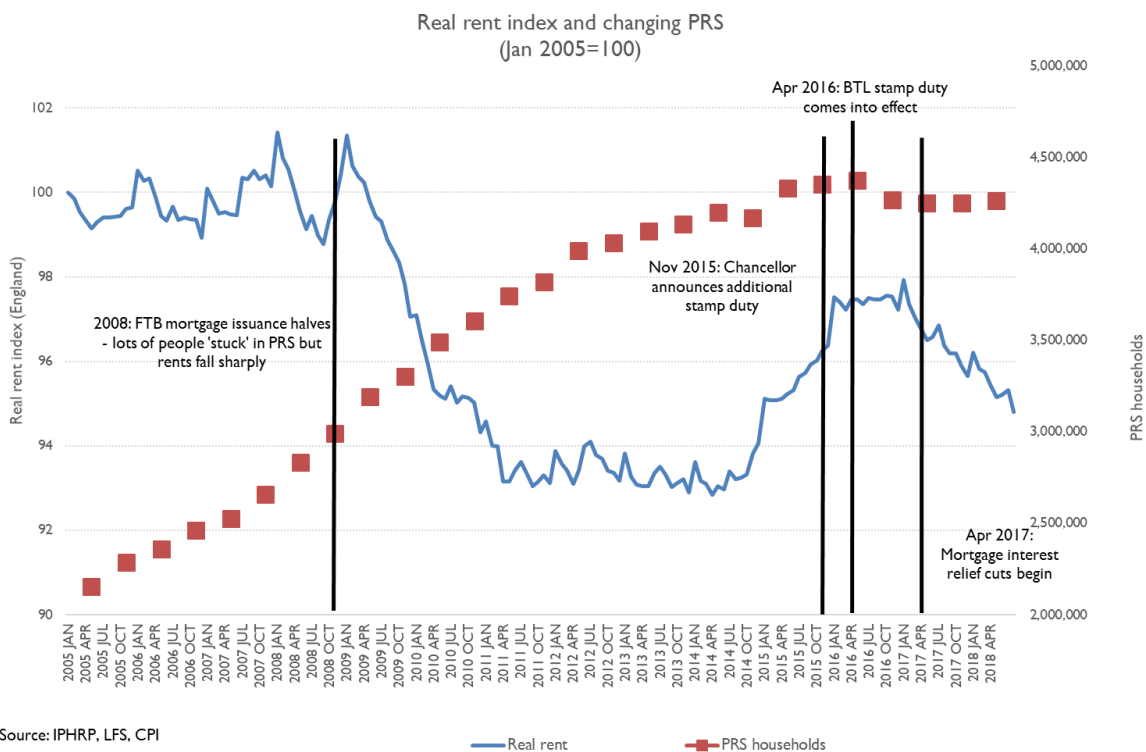
Between 2005 and 2018, there were two ‘shocks’ to the market that affected the size of the private rented sector – one to the demand for rented housing and the other to the supply of it.

First, in 2008, the financial crisis prompted mortgage lenders to withdraw high loan-to-value mortgages from the market. In a matter of weeks, first-time buyers with 5% or 10% deposits were unable to get a mortgage. The number of first-time buyers halved from 402,800 in 2006 to 192,300 in 2008, and the median deposit of remaining first-time buyers jumped from 10% to almost 25%.

The financial crisis therefore caused hundreds of thousands of households, who would otherwise have bought their first homes, to become ‘stuck’ in the private rented sector, while new entrants to the sector continued to start their first tenancies. Between Q2 2005 and Q2 2007, the private rented sector had grown by 186,000 households per year. But between Q2 2007 and Q2 2010, that rate jumped to 321,000 per year.

Did this positive demand shock to the private rented sector cause rents to rise? In fact, the opposite happened, and in the three years from January 2008 rents fell by 6.7% in real terms.

Figure 2: Rents fall in relation to consumer prices following the credit crunch and then since early 2017



Source: IPHRP, LFS, CPI

— Real rent      ■ PRS households

<sup>7</sup> Office for National Statistics, Consumer Price Inflation, <https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/d7bt/mm23>

<sup>8</sup> Office for National Statistics, Quarterly Labour Force Survey Household Data Collection, UK Data Service SN 8389, <http://doi.org/10.5255/UKDA-SN-8389-1> Labour Force Survey series, <https://beta.ukdataservice.ac.uk/datacatalogue/series/series?id=2000026>

The second recent “shock” to the size of private rented sector was the proactive policy of the Conservative government to rebalance the tax treatment of landlords.

First, in the Budget of July 2015, Chancellor George Osborne announced that landlords’ ability to offset mortgage interest against higher rate income tax would be phased out between 2017 and 2020. Landlords would also no longer be able to claim a 10% wear and tear allowance; instead they would only be allowed to claim for repairs actually carried out. Then, in November 2015, Osborne announced a 3% stamp duty surcharge on properties bought in addition to one’s primary residence. This came into effect in April 2016.

From its peak of 4.37m in Q2 2016, just at the point where the first measures began to take effect, the size of the private rented sector subsequently fell by 125,000 by Q2 2018 – a clear negative shock to the supply of private rented accommodation. But what happened to rents?

The ONS private rent index shows us that from April 2014 until February 2016 rents grew by 4.6%, adjusted for inflation, despite the buy-to-let rush ahead of the new stamp duty levy, raising the supply of rented properties in the short term.

But once the stamp duty surcharge was in place and the private rented sector began to shrink, real rents actually stopped rising, and broadly flatlined until January 2017. At this point, three months before restrictions on mortgage interest relief began to be phased in, real rents started falling again. As of August 2018, they have fallen by 3.2% in real terms.

**At every point real rents have done the opposite of what the property industry analysis would have predicted, bearing out the theoretical expectation that a negative shock to the size of the PRS should not be expected to increase rents.**

### **Rent-to-income ratios tell a similar story**

As described above, economic theory tells us that it is the balance of effective demand and the supply of houses across all tenures that determines market rent levels. In practical terms, this means that household incomes are a critical determinant of rent levels, and many of the shifts in inflation-adjusted rents reported above are likely to have been influenced by income changes.

This suggests another approach to identifying any effect on rents from shocks to the size of the private rented sector. Absent changes in the supply of housing or number of households – both of which tend to change only gradually – theory would lead us to expect rent-to-income ratios to remain broadly constant over time. The ARLA/RICS argument, however, suggests that we might expect to see rent-to-income ratios jump in the face of a positive demand or negative supply shock to the private rented sector. Is there any sign of this in the data?

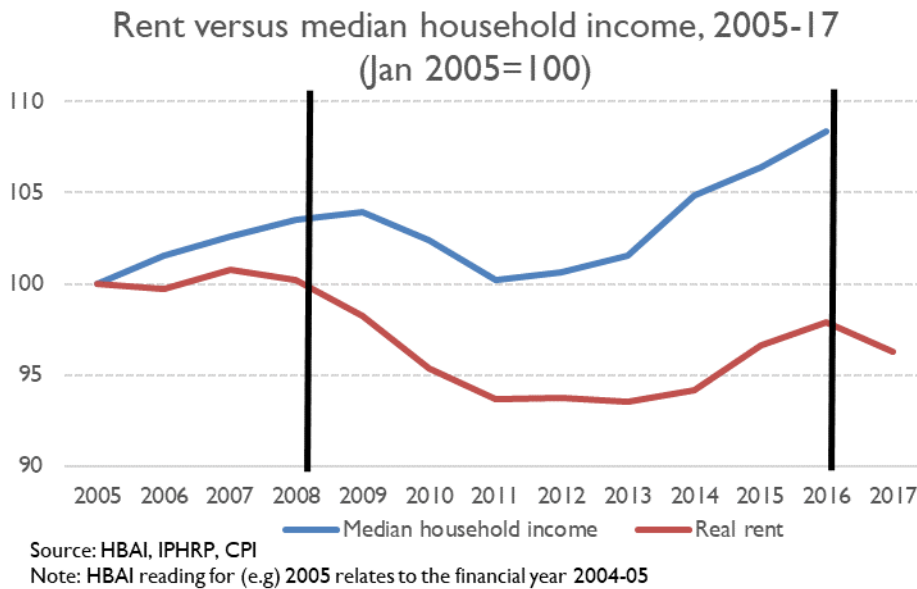
To assess this we use the DWP’s Households Below Average Income measure of median equivalised household disposable income (for the UK) and the IPHRP (for England). The equalisation of HBAI data and the construction of the IPHRP index mean that neither measure is affected by compositional changes: in other words they help us to isolate the changing affordability of a given house for a given type of family over time.

Figure 3 plots the evolution of inflation-adjusted incomes and rents over the past 14 years. After 2008, the start of the positive demand shock to the the private rented sector, household incomes fell until 2011, but rents actually fell slightly more such that the rent-to-income ratio fell somewhat. Again, this is the opposite of what the ARLA/RICS argument would have suggested.



Unfortunately we do not yet have sufficiently timely data to track the rent-to-income ratio into 2017-18. However, the fall in real rents already discussed, combined with real wage growth and stable employment suggests that far from deteriorating, the rent-to-income ratio has continued to improve in the wake of the tax measures applied to landlords since 2016.

Figure 3: Rent affordability has been improving



### There is no reason to expect the growth in housing stock to fall

We have so far seen that, if landlords exit the rental market due to greater regulation, that will not raise rents. But what about the impact reforms would have on new investment?

The objection to proposals to improve security of tenure is sometimes articulated as a fear of reduced investment. This fear is apparently one held by the Treasury, though the nature of this concern is not entirely clear.<sup>9</sup>

There are a few potential scenarios in which reduced investment could manifest itself:

1. Developers building fewer homes as a result of landlords buying fewer of them
2. Landlords building fewer homes themselves
3. Landlords buying fewer houses on the second-hand market
4. Landlords investing less in improving their existing portfolio

In Scenarios 1 and 2, housing supply would not keep up with population growth so we would expect rents to rise. However, neither is likely to occur.

First, landlords do not generally buy new homes. Just five percent of private rented homes had been bought new from a developer, according to research by York University.<sup>10</sup>

<sup>9</sup> <https://www.thesun.co.uk/news/7178128/government-scraps-three-year-contracts/>

<sup>10</sup> The 2010 DCLG Private Landlord Survey, cited by Julie Rugg and David Rhodes, 2018, *The Evolving Private Rented Sector: Its Contribution and Potential*, University of York/Nationwide Foundation, p82  
<http://www.nationwidefoundation.org.uk/wp-content/uploads/2018/09/Private-Rented-Sector-report.pdf>



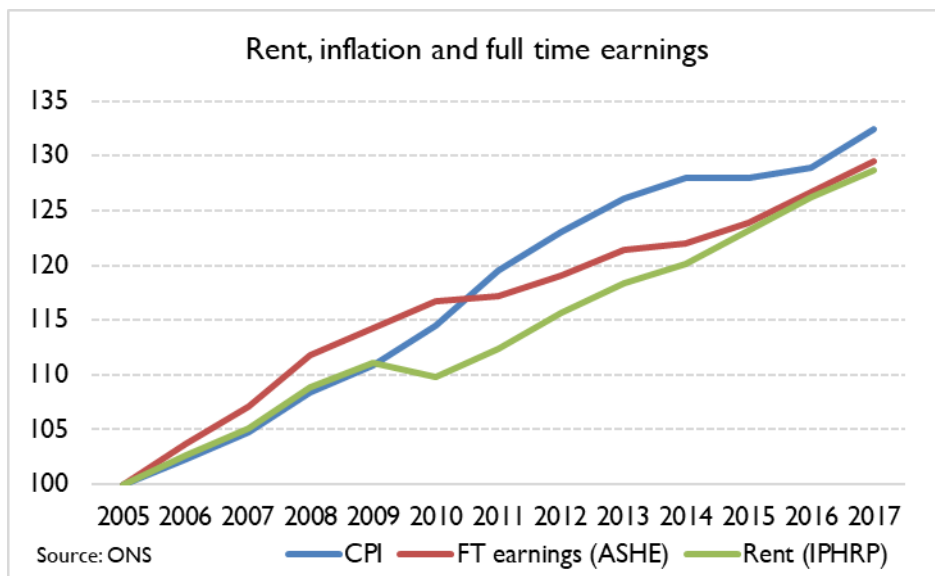
Second, landlords who are most likely to be inconvenienced by improved terms for tenants are unlikely to buy new homes. Landlords who cut corners and intimidate tenants into staying quiet about disrepair are unlikely to pay a premium for a new home. “Accidental” landlords, who see letting out their home as a temporary activity while they live elsewhere, are by definition not landlords at the point when they bought the property. There would therefore be no impact on demand for new homes from these landlords.

Third, many new homes that do enter the rental market immediately are commissioned or built by large corporate landlords who actively seek long term tenants anyway – according to the British Property Federation there were 33,075 “build-to-rent” homes under construction at the end of March 2018.<sup>11</sup> Indeed, leaders from this sector welcomed the government’s proposals in July,<sup>12</sup> and they are generally offering tenancy terms that are as good as, if not better (five years, defined rent caps) than what the government is proposing.

Not only would improved tenant security not impede new supply, consensus among the two main parties over the issue would give the build-to-rent sector some certainty which would allow them to get on with building.

Even limits on rent increases ought not to discourage investment – market rents have broadly tracked earnings over the past 14 years (see Figure 4). Indeed, the primary purpose of limits on rent rises is not to make them more affordable – that requires a separate programme of house building or redistributive policy measures such as social housing and more generous housing benefit – but to prevent unreasonable rent increases being used to force tenants out or intimidate them.

Figure 4: Investors shouldn’t expect rents to rise any faster than wages



We have addressed the implications of lower demand for second-hand properties (Scenario 3) in the sections above. While this is likely, it will not have an impact on overall housing supply and the level of rent.

Reduced investment in existing portfolios (Scenario 4) could see a landlord spending less on maintaining their property, or deciding not to extend it. In the former case, tenants would be paying the same rent for a lower quality home. However, a landlord who fails to ensure that their property

<sup>11</sup> <https://www.bpf.org.uk/media-listing/press-releases/build-rent-sector-grows-pipeline-homes-uk-renters-30>

<sup>12</sup> <https://www.propertyweek.com/news/btr-developers-back-government-proposals-for-longer-tenancies/5097423.article>

is safe to live in is breaking the law. With better security of tenure, the tenant would be in a stronger position to exercise their rights to a safe home and seek regulatory or legal support to force the landlord to make appropriate repairs.

In the latter case, fewer landlords extending their property may theoretically create upward pressure on rent. However, private renters are already half as likely to live in a converted or extended home (21%) as owner-occupiers (41%).<sup>13</sup> If properties move from the rental market to owner occupation, then we should expect overall housing stock to increase as a result.

The only scenarios where a fall in investment would cause rents to rise are where there is slower growth in new housing stock. Both these scenarios are unlikely to unfold because the landlords who invest in new housing stock are better disposed to longer tenancies.

## Conclusion

If the private rental market were hermetically sealed, then a surge in demand or a collapse in supply would indeed see rent levels pushed up. But as we have outlined here, the market level of rent is set not by the balance of supply and demand in the rental sector, but by the balance of supply and demand of the *entire housing market*. Meanwhile, changes to the supply of private rented sector properties have a simultaneous and offsetting impact on the demand for them. Consequently, measures that adversely affect landlords, potentially causing them to exit the market, will not affect rent levels.

As we have shown, the experience of the past 13 years offers no empirical support for the idea that a shrinking private rented sector will push up rents.

While a fall in net investment by landlords in existing housing stock will not affect rent levels for households who remain as renters, a fall in investment in new homes could have a modest impact on overall rates of supply. But there is no evidence that landlords who would be disadvantaged by improved tenant security are investing in new developments. Indeed, much investment in new homes for rent comes from landlords that are seeking long term tenants.

For policymakers this has important implications. Regulation such as greater security of tenure is designed to improve tenants' lives by giving them much-needed stability, and the confidence to exercise their rights to fair treatment and safe accommodation. **Such measures may well result in more landlords deciding to leave the market, causing the private rented sector to shrink and home ownership to rise. But there is no reason to think that in doing so they will make tenants financially worse off.**

## Acknowledgements

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Generation Rent is part of the End Unfair Evictions coalition alongside ACORN, London Renters Union and New Economics Foundation. More information at [www.endunfairevictions.org](http://www.endunfairevictions.org).

Figure 1 designed by Abi May - <https://www.abimaydesign.co.uk/>.

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<sup>13</sup> English Housing Survey, 2016-17, Home Ownership Report, Annex Table 4.2