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Economics Revision Focus: 2004

AS Economics

Housing Market Failure

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Revision Focus on Housing Market Failure

AS Syllabus Requirements (Paper 3)

Students should be able to consider evidence for market failure in the housing market and assess the merits of different types of government intervention to ease the problem

Market failure:

Market failure is when a freely functioning market fails to operate efficiently and equitably leading to a **misallocation of scarce resources**. When market failure occurs, there is **allocative inefficiency** i.e. *it is possible to make someone better off without making someone else worse off*.

Market failure represents a **loss of economic and social welfare** because the market is failing to meet people's changing needs and wants.

It is important to realise that housing is a series of interlinking sub-markets. These sub-markets are defined mostly in terms of tenure (e.g. owner-occupied, private rented), house type (e.g. large family house, two-bed flat, small terraced house) and geographical location (e.g. regional, city, or local neighbourhood). Examples of market failure are more obvious in some regions and areas than others.

Inefficiency and market failure are seen as endemic in the housing market. Economists point to whole variety of areas of market failure: capital market imperfections, imperfect information and discrimination, the existence of externalities, and adjustment problems due to short run supply inelasticity.

London Housing Market Review, May 2003, Office of the London Mayor

We will consider a small number of examples of market failure – this is not an exhaustive list

1. Under-supply of affordable housing – equity concerns

In a country increasingly obsessed with house prices and home improvement, over one million children can only dream of the home so many take for granted

Adapted from the Shelter web site www.shelter.org.uk

Millions of people have benefited from the recent boom in house prices. But there are many hundreds of thousands for whom the housing boom has meant nothing. Indeed, worse still, it has made most forms of housing unaffordable and has made even basic accommodation beyond their financial means. According to Shelter www.shelter.org.uk affordable housing is now one of Britain's most pressing policy issues. In many areas the shortage of affordable housing has now reached crisis point. Low levels of new housing building, coupled with rising house prices have tightened the market to the extent that even those on moderate incomes are often unable to access housing that they can afford.

Unaffordable housing means that people are missing out on what is viewed by many as an **essential social need** – each £1 of income that people have in the market place is an **economic vote** – when housing becomes so expensive, thousands of households become disenfranchised from the housing market – it is failing to meet their individual needs. Research published recently by the Joseph Rowntree Foundation found that in Britain, 41 per cent of poor adults live in social housing and 9 per cent are in the

private rented sector. In other words, approximately half of poor households (i.e. those living in relative poverty) are home-owners.

Roger Bootle emphasised this point in an article in the Telegraph in February 2004:

For society as a whole the fact that house prices have risen so far is a mark not of success but of failure. The losses are felt by all those millions of people who cannot afford to buy a home or who are constrained by the level of house prices to live in cramped or inadequate accommodation

2. Poor quality housing, empty homes and housing poverty

Over one million children in Britain live in bad housing - enough to fill the cities of Edinburgh, Bath and Manchester. More than half a million families in Britain live in officially overcrowded housing. People with asthma are twice as likely to live in damp homes (www.shelter.org.uk)

Millions of people live in **housing in poor condition** both in the private sector and in social housing. The Government has identified a £10 billion backlog of overdue renovation work particularly in local authority estates many of which were built to poor standard of design and construction.

The poor quality of much of the housing stock has an effect on the **standard of living** of millions of people. There is evidence that poor housing contributes to a decline in life expectancy and increased incidence of illness. This imposes **extra costs on the National Health Service** and other Social Services. To these **external costs** we might add the impact of poor housing conditions on the educational attainment level of thousands of school children.

Persistent poverty remains a major barrier to obtaining good quality housing in Britain. The most economically and socially disadvantaged people in society tend to live in the worst housing.

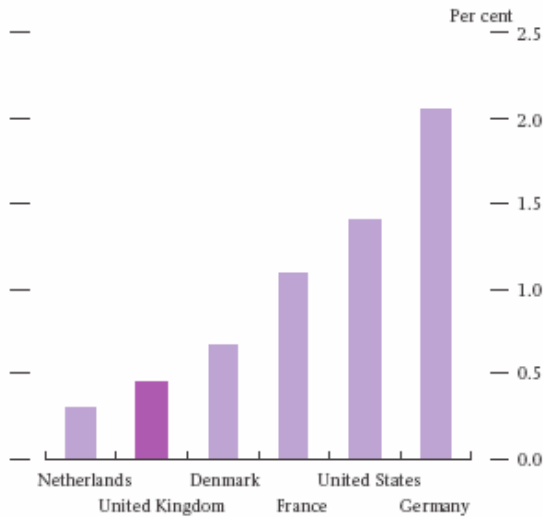
Region	Total empty homes 2003
North East	44,349
North West	135,106
Yorkshire & Humberside	87,855
East Midlands	57,835
West Midlands	74,312
East of England	63,418
London	99,781
South East	80,690
South West	75,374
England	718,720

Source: Empty Homes Agency, press release, February 2004

Housing is a scarce resource – yet the British government calculates that **over 750,000 homes are empty** at a time when total housing demand is exceeding supply in many parts of the country. This is clearly an **allocatively inefficient use of the available housing stock**. This paradox is partly explained by the fact that demand for certain types of property in some areas and regions is low – making it unprofitable for people to rent these properties out or attempt to sell them on the open market.

3. Low price elasticity of supply – housing supply is unresponsive to demand conditions

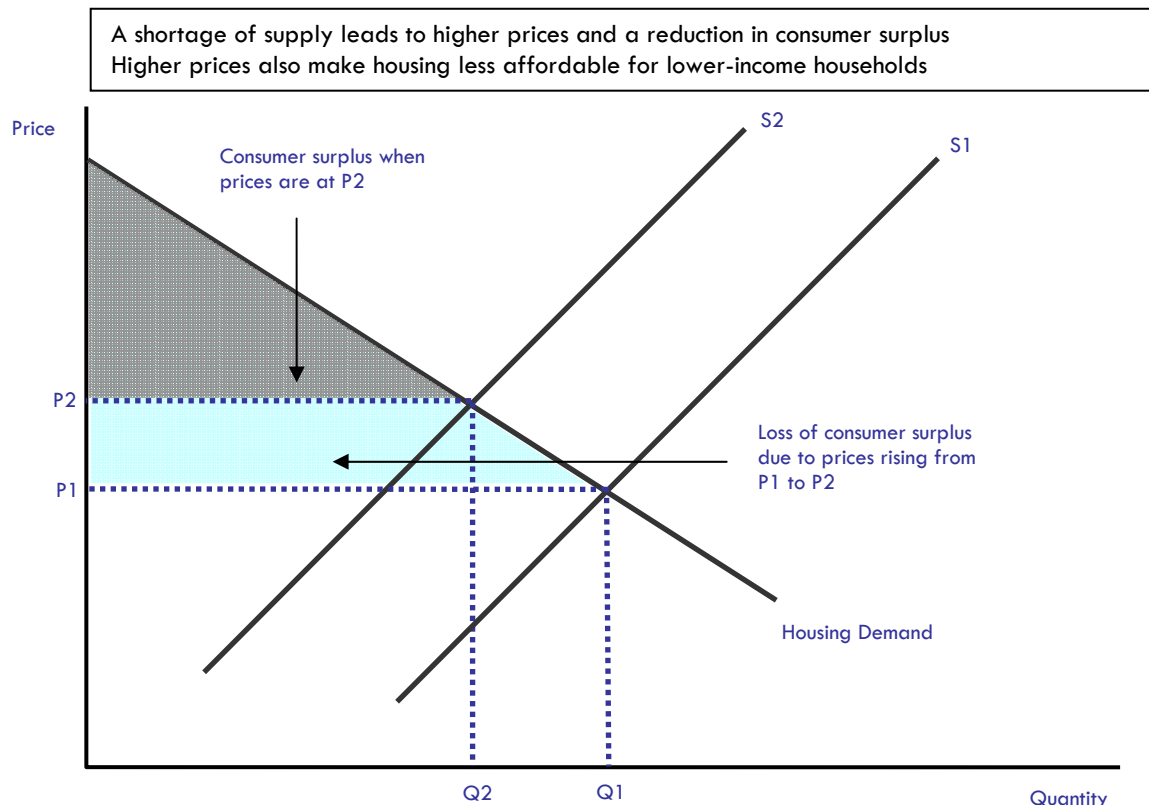
Estimated response of new housing supply to a 1% change in house prices



The supply-side of the housing market is a constraint to the efficiency of the housing sector. The 2004 **Barker Review** concluded that historically, **housing supply has been unresponsive to changes in price** - three times less responsive than in the US and four times less responsive than Germany. (See the chart opposite).

Inadequate levels of house building constrain economic growth, damage the flexibility and performance of the UK economy and reduce living standards for everyone. Regional price differentials also reduce the **geographical mobility of labour** leading to higher levels of **structural unemployment**.

The Barker Review characterised the housebuilding industry as being labour intensive and suffering from weak levels of innovation. Commercial house builders' **aversion to risk** meant that they were reluctant to develop new homes on derelict brown-field land, and use new building techniques such as prefabricated homes. Another complaint was that the leading home-builders deliberately restricted new housing supply in order to keep prices and profits high. This raises the criticism that they are using their **monopoly power** in the housing market to raise prices and increase profits.



4. Externalities from new housebuilding

The solution to the housing shortage is not necessarily simply to build more houses although, given the projected increase in the number of households, rising housing demand will need to be met by an expansion of housing supply.

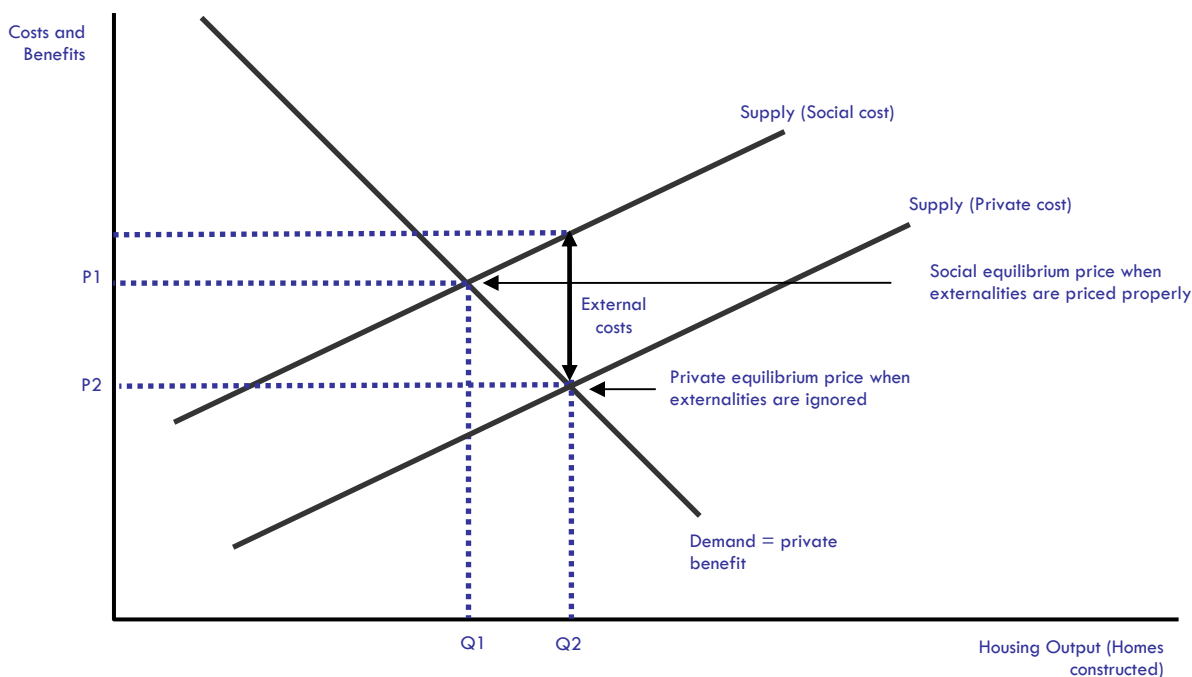
Housing supply can be met by three main means:

- (i) Building new houses
- (ii) Getting empty houses back into use
- (iii) Converting non residential buildings into residential use

But constructing new housing developments involves externalities that the free-market may not take account of. The environmental costs of building new homes include:

1. **Flora and fauna:** The destruction of some natural habitats, greenfield areas and other open spaces given over to housing developments
2. **Pollution:** Noise, air and other forms of pollution created by the construction industry and household waste and other pollution created by the population moving into new housing
3. **Congestion:** Increased traffic congestion due to a rise in population density
4. **Pressure on public services:** Increased pressure on public services and infrastructure arising from an increase in population density – for example an increase in policing costs and education and health services
5. **Neighbours:** The impact on property prices of existing homeowners in areas and localities where new house building developments are planned. This effect can be important when the quality of new housing developments is poor – often the result of developments being rushed through in order to reduce a short term housing shortage problem

If the construction of thousands of new homes leads to increased external costs (e.g. rising pollution, congestion and waste) then the social costs of housebuilding will exceed the private costs, and market failure may result -



5. Volatility of the housing market caused by too much speculation

The volatility of house prices causes problems for both home-buyers and home-builders.

For home-buyers, there is a **lack of information in the market**. They cannot actually predict what is likely to happen in the local or regional housing market in which they are potential buyers. There is **no market for insuring against falling house prices**. And, when house prices rise to very high levels because of speculative demand, thousands of people are priced out of the market for no other reason than the speculative activity of other people.

For construction companies, house building is a risky business due to fluctuations in house prices and the time lag between land purchase and the completion of any housing development. The structure of the industry in the UK, with its predominance of small building firms, contributes to a tendency towards being risk averse. This may be a factor behind the low level of current house building which is adding to the price boom.

6. Inefficiencies in the system of housing transactions

The system of home buying and selling in England and Wales is one of the slowest in Europe. It can take around eight weeks to get from offer acceptance to exchange of contracts and over a quarter of offers for a property fail after acceptance. It is very costly to buy and sell a house in the UK – the market does not work effectively and this causes a loss of economic welfare.

Imperfect information: One of the major problems in the housing market is the **imperfect information** among buyers and sellers. The would-be buyer of a property rarely has full information on the state of

the house or flat. The seller may indeed with-hold information and the estate agency is clearly at risk of over-selling properties in order to gain commission sales.

This asymmetry in information can be addressed in part by government policy. The new **Seller's Pack** comes into force in 2005. Sellers will be compelled to compile key information about their property including a basic survey and local authority searches before putting it on the market. The aim is to give buyers much more knowledge in advance of putting in an offer and spend less time chasing documents before a contract is exchanged and to reduce in the time taken to complete the home buying process.

Government intervention in the housing market – are there solutions to market failure?

Statement of current UK housing policy

Our aim is to give everyone the opportunity of a decent home, and so promote social cohesion, well-being and self-dependence. This site sets out the action we are taking, from increasing the provision of affordable housing in areas of high demand, to addressing the problems of low demand and abandonment

www.odpm.gov.uk

There is a long history of government intervention in the housing sector designed to correct for previous housing policy failures which have served to deepen existing market failures!

The current government is acutely aware of the inefficiencies of the housing sector and the economic and social consequences of a housing industry that is failing to meet people's changing needs and wants. Some of the recent policy initiatives are summarised below:

1. **More homes:** Policies to increase the rate of housebuilding – including some huge new housing developments in parts of the south-east. The government is to give the go-ahead for building more than two million houses over the next decade in an attempt to rein in house price inflation which is preventing millions of people buying their own home. Critics of the government argue that these house-building schemes are too little, too late and will do little to resolve the problem of housing shortages in congested areas. In the longer term, the government may have to relax planning regulations to increase the supply of available land for housing developments
2. **Better information:** The introduction of the Sellers' Pack designed to reduce some of the information asymmetries between buyers and sellers
3. **Stimulate demand in depressed areas:** Reductions in stamp duty in areas of high unemployment and low house prices – designed to boost housing demand
4. **Raise the cost of second homes:** Increasing the council tax paid by owners of second homes
5. **Windfall taxation** on the profits of land developers – the revenue might be used to fund improvements in the stock of social housing
6. **Address key worker shortages:** Launch of key worker housing scheme – aimed at helping key workers in London, the South East and East of England to buy a home, upgrade to a family home or rent a home at an affordable price – the scheme offers 'equity loans' of up to £50,000 to help key workers buy a home on the open market or a new property built by a registered social landlord.
7. **More diverse types of home-ownership:** Encouraging the expansion of part-ownership, part-rental schemes to improve housing affordability for lower income households – this allows people to own at least 25% of the home and pay a reduced rent on the remaining share.

8. **Improve standards:** Regulations to improve the overall standard of private sector rented accommodation – this will help to reduce some of the external costs of unacceptable standards found in many rented properties
9. **Improving the social housing stock:** Allowing local authorities to borrow money from the capital markets (or the revenue from the sale of council houses) to invest in improving the standard of their own housing stock. And encouraging local authority tenants to vote to allow housing associations and other agencies to take over the running of estates and promote new investment on housing improvements

No easy short-term solutions to the failures of the housing market

We estimate that the difference between housing demand and supply will have widened into a yawning gap of 1.1 million homes in England alone by 2022: most of it in London and the South East. This genuinely shocking statistic shows why the time has come for policy makers to recognise that a plentiful supply of new and affordable homes is of the greatest importance the nation's future health and prosperity

Lord Best, Joseph Rowntree Foundation

There are no easy solutions to the UK's housing crisis. The country as a whole needs to make better use of our existing housing resources (e.g. reducing the problem of empty homes) and we need to strike a better balance between house prices in each of our regions.

For several million people, the UK housing market is not working properly and is restricting people's housing choice. Millions of people on or below average incomes can struggle with accessing and maintaining home ownership, but they are also often excluded from social housing and they find private renting a poor quality or unsatisfactory option

There is a desperate need to improve the supply of affordable homes, both in the social housing sector (local authority and registered social landlords) and also in the private sector. It will take many years for housing supply to become more elastic in response to changing housing demand and price