

# Under- standing the Role of Private Renting

– *A Four-Country Case Study*

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*Report for the Knowledge Centre  
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June 2016

Funded by

**BOLIGØKONOMISK  
VIDENCENTER**

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# Executive Summary

## INTRODUCTION

After decades of decline, private renting has started to expand again in some European countries, often as owner-occupation falls. Two projects supported by the Knowledge Centre for Housing Economics have looked at the reasons for decline and for increased interest in the sector as well as the factors which might lead to increased investment in private renting into the future.

The first project looked at how regulation of the private rented sector (PRS) had developed since the 1980s in 11 European countries, and asked whether and how regulation and changes in regulation affected the scale of private renting across countries. The findings were clear: deregulation generally does not lead to growth in the PRS. With the clear exception of England, deregulation has generally been associated with continued decline in private renting. On the other hand, countries that still have large PRSs are generally quite highly regulated, but with sophisticated regulatory frameworks which provide considerable certainty for both landlords and tenants.

## THE CURRENT RESEARCH QUESTION

The current research concentrated on achieving a better understanding of the drivers of change and particularly on the incentives faced by households to become owner-occupiers or tenants and for different types of landlord to invest in private rental housing.

The core research question was:

‘How do incentives and constraints around private rental provision work in different institutional, economic and policy frameworks, and what factors might incentivise investment in private renting and produce an efficient and flexible sector to meet household requirements?’

Unlike the original project, which compared experience across a large number of countries but did not attempt to make recommendations, the intention in this project was to concentrate on in depth analysis of a small number of countries; to look to the future and to suggest lessons for the Danish system where appropriate.

## METHODOLOGY

The approach involved detailed literature and data reviews of private renting in Denmark, England, Germany and the Netherlands as well as case studies supported by country specialists and roundtables with academics and practitioners in England, Germany and the Netherlands. A core element of the research was a review of the literature on the determinants of economic and financial decisions notably in the context of user cost analysis. This formed the starting point for a statistical analysis of user costs of private renting as compared to first-time buyers for all four countries. Together these elements allow us to look at the factors determining the role of private renting in these very different environments, to

suggest future scenarios and, particularly to bring out implications for the Danish housing market.

The main drivers of the size and role of the PRS, as identified in the literature and at our roundtable discussions, include:

1. the PRS regulatory framework and changes in that framework;
2. the tax and subsidy framework for the PRS and for alternative tenures;
3. the economic environment in which decisions are made;
4. the interaction between economic variables and other incentives- notably the tax framework;
5. constraints on households' entry into other tenures; and
6. attitudes of landlords and tenants to the sector arising from past experience, the type of stock available, terms and conditions and other factors.

It is these factors which frame the detailed analysis of private renting in the four countries.

## **THE CURRENT POSITION OF THE PRIVATE RENTED SECTOR IN THE FOUR COUNTRIES**

The private rented sectors in these four countries are diverse in their size – ranging from under ten per cent to over 50 per cent - and composition. Patterns of growth and decline are also specific to each country. The extent to which private renting is seen as a mainstream tenure varies greatly – with private renting seen as the ‘normal’ tenure for all types of household in Germany; while in other countries with smaller sectors it tends to be concentrated more on younger more mobile but also poorer households.

Nevertheless, there are similarities in terms of the location of the private rental stock (mainly in cities and large urban areas) and the profile of private landlords (overwhelmingly individuals rather than large companies or institutions). The country that stands out as different here is the Netherlands where longstanding company landlords are an important part of a declining sector which is now the smallest in Western Europe.

New-build dwellings, either purpose built for private renting or simply purchased by landlords, generally account for a relatively small part of overall housing output. In England, new purpose-built private rental dwellings are rare. Buy-to-let interest only mortgages have played an important role in expanding the proportion of new build going into the sector. Housing associations have also become increasingly involved in providing market rental housing. In Germany new rental units may similarly be purchased by owner-occupiers or by private landlords - either as blocks of flats or singly. There has been almost no new build provided in the PRS in the Netherlands for many years. The fact that higher valued units are not regulated has not significantly changed this position.

## **HOW THE PRIVATE RENTED SECTOR HAS DEVELOPED IN THE FOUR COUNTRIES**

To some extent the housing systems in each of the four countries have passed through similar stages of development, although particular policies were implemented at different times and trajectories have been significantly different especially with respect to private renting. However, the demand for private renting has been growing recently partly because of increasing affordability problems, the impact of the global financial crisis on access to mortgage finance and the consequences of the recession on both individual incomes and public revenues.

It is also clear that rent deregulation is not a sufficient condition for the stimulation of private investment in the form of either new construction or renovation and repair in the PRS. Moreover, where regulation remains strong it may well be constraints on movement out of the sector and the lack of other options which help to maintain the supply of private rental housing.

## **DRIVERS OF CHANGE IN THE PRIVATE RENTED SECTOR IN ENGLAND**

The post war English housing system has been typified by four main periods strongly linked to political change. The four stages we identified are all associated with particular governments and their different ideologies. Governments pursued their policy goals by

- changes in regulation – not just of the PRS but also of the finance market, which modified households' capacity to choose tenure, and of social sector powers and responsibilities with respect to homelessness, the right to build and the Right to Buy;
- changes in subsidies to the social sector, to owner-occupiers and to tenants; and
- tax changes, notably with respect to owner-occupation and the PRS.

However, the importance of particular policy interventions varies with the economic environment, notably income growth, which opens up housing and investment choices to government and consumers alike; inflation, which interacts with the tax system massively to change the incentives for households to be in a particular tenure; and macro-economic volatility, which changes both interest rates and the risks around tenure choices and interacts with macro-stabilisation policies to expand or limit choices notably in response to the global financial crisis.

In the English context, the most important events that could be expected to change incentives were:

- 1957 when major rent decontrol was introduced (user-cost increases for PRS tenants; returns on landlord investment increased - but not to competitive levels);
- 1974 when income related benefits for private tenants were introduced (net user cost for PRS tenants falls);
- 1977 when the Homeless Persons Act was passed giving local authorities responsibility for re-housing those accepted as homeless in later periods {increases demand for PRS);
- 1980 when there were regulatory changes both to the PRS and to the finance market for owner-occupation plus the Right to Buy for council tenants came into force (reducing demand for PRS - but in later periods increasing supply);

- 1989 when full decontrol of rents and short term security of tenure were introduced and at the same time the economy and the housing market faced a major downturn;
- 1996 when buy-to-let mortgages first became available while there were continuing innovations in finance for owner-occupation (increased the number of landlords able to invest though may not have affected expected returns for individual investors);
- 2007/8 the global financial crisis resulted in massive shortages in credit availability, reduced transactions in the owner-occupied sector and pushed both supply and demand into the PRS; and
- 2015 when changes in subsidies and tax reliefs were introduced (returns to small individual landlords reduced and incentives to enter owner-occupation increased).

Even so, private landlords have remained in a relatively poor tax position both as compared to owner-occupiers at least with respect to capital gains and as compared to investments that allow depreciation. The 2015 changes worsened that position.

### **DRIVERS OF CHANGE IN THE PRIVATE RENTED SECTOR IN GERMANY**

In general, subsidies and tax incentives are tenure-neutral, except during 1997 to 2005 when a one-off subsidy programme was introduced to increase homeownership. Overall, after significant cuts in government expenditure, there is today very little subsidy to homeowners or landlords (private or social) in Germany.

With reunification Germany experienced a seismic political change that had no parallel in the other three countries studied. Nevertheless, in the realm of housing policy on the whole the picture has been one of steady, incremental change; there were few fundamental shifts in direction.

Over the last several decades tenants have experienced a steady relaxation of rent controls, from frozen rents in the 1950s to cost rents and now freely-set initial rents and *Mietspiegel*-based rent rises. This relaxation never reached the full decontrol seen in England, for example, and recently the relaxation itself has been reversed with re-imposition of controls on initial rents in some high-cost cities. Those policy changes that might be expected to affect relative user costs for tenants, landlords and owner occupiers include:

- 1954 rent law, allowing increases in previously frozen rents
- 1958 – 1971: gradual relaxation of rent control
- 1965: introduction of housing allowance
- 1971: introduction of comparable rents system
- 1976: tax concessions for owner-occupiers buying existing buildings
- 1990 onwards: incorporation of eastern Germany and its housing
- 1997 -2005: *Eigenheimzulage* subsidy for first-time buyers
- 2015: new initial rent limits in high-cost areas.

### **DRIVERS OF CHANGE IN THE PRIVATE RENTED SECTOR IN THE NETHERLANDS**

The PRS has shrunk enormously in the post-war period, even though one could speak of a tenure-neutral subsidy policy between social and private renting. For many decades organisational (in particular institutional) investors have retained market share because of this

policy. However, many private individual landlords have sold their stock. In recent years, even institutional landlords are finding returns from renting less attractive, and their market share has fallen more or less in line with the reductions in bricks-and-mortar subsidies. On the demand side, the subsidisation of homeownership via income tax drove down demand for private renting.

With falls in house prices and construction, stricter loan regulation and stricter allocation of social rental dwellings, all the signs seem to point to increased demand for private renting. However, with the introduction of a landlord levy in force until 2017 and an uncertain future thereafter, the expansion of the PRS is questionable.

The major changes in policy that could be expected to affect user costs for tenants, owner-occupiers and/or landlords include:

- 1967: rents could be raised on new tenancies (to average for subsidised new-build);
- late 1960s: housing associations assume major role in new housing construction, including for market homes;
- 1968: bricks-and-mortar subsidies made available equally to social and private landlords; tax exemptions for corporations investing in rented homes;
- 1970: introduction of housing allowances;
- 1989: liberalisation of rents for new dwellings at top of market followed in 1994 by rent liberalisation for higher valued existing units when the tenancy changes;
- 1990s: ‘grossing and balancing’ operations—government wrote off both social and organisational landlords’ debts and paid them the present value of the future subsidy commitment, then stepped back from direct support;
- 1992: tax exemption for corporate landlords was removed for new construction and for existing stock in 2004;
- 2009: state aid considerations meant that social landlords must focus on low-income tenants.

## **USER COST: THE QUESTIONS**

User-cost analysis can shed light on three sets of questions:

- what are the relative consumer user costs of renting and owning in each of the four case-study countries, and what does that imply for household tenure choice?
- what are the relative returns from investing in existing residential rental property and alternative assets, and how does that affect the behaviour of potential investors?
- given each country’s taxation and regulatory systems, would an investor want to add to the stock of privately rented property?

User costs are not fixed but vary frequently as a result of changes in economic variables such as interest rates and house prices and policy-related variables which can exhibit sharp discontinuities including taxes, interest rates, cost of letting (e.g. if standards are changed/imposed) and the proportion of price borrowed (e.g. if LTV limits are changed/imposed).



For each country we produced a qualitative timeline identifying important changes in policy or regulation affecting the PRS or other tenures. These could produce inflection points or discontinuities that might change relative incentives.

## **USER COSTS: THE EVIDENCE**

The starting point is: prospective tenants will choose between private renting and owner occupation based on the relative user costs, and landlords will invest in private renting if the expected risk-adjusted return is higher than what is available on alternative investments.

The user cost approach allows us systematically to identify and quantify the various elements that contribute to the end cost of housing, and to carry out hypothetical exercises to see what would happen to relative costs if certain assumptions were changed. As such it provides a basis for cross-tenure comparisons within countries and could also, in principle, allow comparison across countries.

However there are practical difficulties including data availability; timescale as adjustments are not immediate; whether we wish to analyse *ex ante* or *ex post* - ie before or after decisions are made; and influences that are hard to quantify such as cultural attitudes to home ownership and the timing of initial house purchase; the individual's expectations about job security; and the degree of tenure security in the PRS.

While the user-cost analyses give some very general indications of the relative benefits of different tenures over time, this technique has some serious drawbacks when used to investigate these questions. Some of the issues include:

- a proper comparison between owning and renting would be based on identical units, but we know that in fact the typical dwellings in the two tenures are often very different;
- the question of whether to live in a property or let it out is generally answered at the time of purchase. Equally the investor can only live in one unit. This question, then, is better addressed by examining how profitable letting is compared to other possible investments;
- user costs are measured at a point of time - they are not present-value calculations as would normally be employed by investors; and
- our calculations are generally *ex post* although decisions have to be made *ex ante*.

Importantly direct comparisons between the four countries are not possible not only because of differences in data availability but in the fundamentals of how each system works. It would require a far more formal assessment in each country before statistical comparisons could be made. While the findings are necessarily limited, they suggest that

- most changes in policy, tax, regulation or the economic environment are 'slow burners' – their impacts are not immediate, but become apparent over the course of many years;
- there are often too many changes going on at the same time to allow us to isolate the impact of an individual one - the system works as a whole;

- because housing and investment systems are only rarely, if ever, in equilibrium when changes occur, the impacts may not be as large or even in the direction expected; and, perhaps most importantly,
- changes in the economic environment affect the sector more obviously than tweaks of policy levers.

The analysis identified only one case of a change with an apparently clear immediate impact: the 1996 introduction of the buy-to-let mortgage in England. This overcame an important credit constraint and clearly contributed to a turning point in the growth of the sector. It should be noted that this was a private-sector initiative rather than a government policy.

In comparison, several countries have introduced policies aimed at incentivising institutional investment in the PRS. These have as yet had almost no effect, suggesting that rental rates of return are not yet high enough to change the behaviour of this class of investor.

## IMPLICATIONS FOR DENMARK

Denmark is unusual among European countries in having a system where the tenure of dwellings is determined at the time of construction. Denmark is also unusual in that national rent deregulation enacted in 1991 was limited to new buildings. Pre-1991 units are still subject to strong rent regulation and all types of rental housing are also subject to local regulations in some areas.

The evidence from the three other countries on the effects of rent regulation varies, but suggests that traditional rent controls will normally incentivise landlords to exit the market by selling into owner-occupation or some form of condominium as relative rents decline. However German experience suggests that a more sophisticated approach to providing a stable framework giving landlords and tenants greater certainty can work well in a low inflation economy.

The extent of *new* investment in the PRS – whether into newly built units, transfers from other tenures or investment in repair, maintenance and improvement – reflects investor choices based on the expected rate of return on that investment compared to other possible opportunities. Many European governments seek to increase institutional investment in the private rented sector sometimes with the help of tax reliefs, guarantees and other support. So far the evidence is that very little has actually been invested. It is generally accepted that if they are to invest, institutions require four conditions:

- a suitable stock of purpose-built units to allow cost efficient management and provide flexible accommodation for tenants;
- rents that rise with tenant incomes, so matching the structure of the institutions' outgoings;
- the assurance that they can gain repossession if the tenant fails to meet the terms of their contract; and
- a stable tax and regulatory framework.

The country that best meets the requirements for institutional investment is Germany. Even so, most landlords in Germany are individuals or small companies and there has been little institutional activity, except to the extent that private equity has purchased social rented

stock. In England there has been rapid growth in the sector but there is little existing stock that meets institutions' requirements; most new sites are multi-tenure and there is very little purpose-built PRS stock.

Finally there is the question of demand. In all three comparator countries there is evidence of growing demand for private renting, at least in major cities. In England the increased demand is evident nationwide.

The growth in demand is driven by a number of factors, including in particular (i) shifts in economic activity that have increased the incentives for younger people and more mobile households to locate in big cities and university towns; (ii) the very considerable growth in the number of students (both national and international) in higher education; and (iii) evidence that younger households are increasingly choosing to rent, partly as a result of the more risky labour market environment; partly because of increasing credit constraints; and partly because of better choice in the sector.

In much of Denmark there is social housing available for the sorts of households who would be private tenants in other countries - which is not the case in either England or Germany. Most of the new demands are concentrated in Copenhagen, which has some new developments for upmarket rent.

Overall the potential, and in some cases actual, importance of private renting is growing rapidly. However none of the four case-study models has yet demonstrated the ability to generate significant additional investment. Instead, in those countries where units can be readily transferred between tenures, high relative returns has led to increased transfers rather than to dedicated new construction. In other countries, especially those where there are calls for and in some cases legislation on stronger rent controls, new tenants are finding it harder to access rented housing at rents they can afford while institutional investor interest in particular has flagged.

Into the future, as younger households make different life choices, access to credit remains restricted and government budgets for social housing come under increasing strain, private renting is likely to grow. The objective must be to provide a tenure neutral environment in which tenants, landlords and investors are all in a position to make the choices that best meet their objectives. This requires considerable new investment particularly in thriving central city areas. Most importantly it requires governments to provide stable regulatory, subsidy and taxation frameworks that allow all tenures to make effective contributions to ensuring adequate housing for all.

# Chapter 1: The research question

## 1.1 INTRODUCTION: THE OBJECTIVES OF THE PROJECT

In most European countries, the private rented sector (PRS) had been in decline over the last few decades at least until the turn of the century. Except for those parts of the sector that provide for better-off mobile households and young people (especially students), private renting has a relatively poor reputation in many countries. There are exceptions – notably Germany and Switzerland – where the tenure is seen as appropriate more generally and where the types of household that live in the social sector or in owner-occupation in most other European countries are well housed by private landlords.

Over the last few years, the position of private renting has begun to change. The PRS is now growing in many European countries, for both positive and negative reasons. On the one hand, owner-occupation has become more difficult to access, especially since the global financial crisis, while social renting has faced increasing pressure from the impacts of recession and public expenditure cuts. On the more positive side, labour is becoming increasingly mobile, and this mobility is often best served by renting privately. There is also growing demand from households who see owner-occupation as not for them, at least for the moment. Again, the exceptions are in Germany and Switzerland, where owner occupation now appears to be growing at the expense of private renting.

This revival has brought two issues to the fore. First, as the scale of private rental grows, housing often does not meet the aspirations of the new groups entering that market with respect to standards, rents and security of tenure. England is a good example here in that large numbers of family households are now coming to live in the sector while the level of tenure security and physical attributes of the units are often unsuitable (Whitehead et al, 2012; Hulse et al 2011). Equally, landlords do not have strong incentives to provide that quality at an acceptable rate of return. The second major problem is that increased demand has not translated into investment in additional housing. In many of the countries where private renting is expanding, overall investment in residential construction has declined and new building is not keeping pace with demographic pressures (Lunde and Whitehead, 2016).

In most countries, the additional supply of private rented units comes largely from dwellings that were previously owner-occupied or in the social rented sector. Moreover, the existing stock is being used more intensively – with fewer vacancies and higher occupancy levels. This in turn means that housing market pressure is rising, reducing households' ability to achieve the standards of housing to which they aspire. A number of governments are now introducing policies to support the construction of good quality purpose-built private rented housing that can play a larger role in the overall housing market while at the same time looking to ways to encourage long term stable institutional investment in the sector, but most such policies are only in the early stages of implementation (see eg Scanlon et al, 2013).

Given the growing political interest in enabling growth in the sector, the Knowledge Centre for Housing Economics at Realdania funded our original research project looking at the effects of regulation on the scale and nature of the PRS across Europe (Whitehead et al, 2012a). The emphasis on regulation in that project - particularly of tenure security and rents - arose because it is seen by many market oriented commentators as the main reason for the

decline in private renting – and therefore deregulation is seen as the answer. The report made it clear that the picture is much more complex as some types of regulation hastened decline while others improved the operation of the market. It also showed that many other factors need to be taken into account when assessing the potential role of the sector in well operating housing systems.

This second project takes on this broader perspective by examining the full range of factors and how they have acted together in different environments to generate different outcomes and prospects. It concentrates on only four countries, allowing a more in-depth analysis of the drivers of private rental demand and supply and how they constrain or support a well-operating private rented sector. The goal is better to understand these processes in different institutional and market contexts and specifically to draw lessons about what could be done to help Denmark's private rented sector to work more effectively.

## **1.2 FINDINGS FROM THE FIRST PROJECT**

The first project looked at how regulation of the PRS had developed since the 1980s in 11 European countries, and asked whether and how regulation and changes in regulation affected the scale of private renting across countries. The findings were clear: deregulation generally does not lead to growth in the PRS. Where it has done, notably in England, more than a decade elapsed before the sector grew significantly, and a number of other constraints had to be removed before significant expansion took place. Mostly, deregulation has been associated with continued decline in private renting, although there have been exceptions as, for instance, in Ireland. On the other hand, countries that still have large PRSs are generally quite highly regulated, but with sophisticated regulatory frameworks which provide considerable certainty for both landlords and tenants and involve rent stabilisation based on defined indices as in, for example, Germany and Switzerland.

What these findings indicate is that the regulatory framework is not the only – or even the main – incentive or constraint affecting the tenure structure in different countries. Effective and responsive regulation that improves the operation of the market rather than limiting rents below market levels would seem to be a necessary condition for a well-operating PRS of whatever size – but it is not the only determinant of scale and the suitability of the sector for different types of households.

This report therefore looks in more detail at the factors that determine the overall tenure mix in each of the four countries, the size and role of the PRS – and particularly at those affecting the level of new investment. It is clear that the relative importance of the various factors varies by country. Different legal and administrative frameworks, demographic structures, income distributions as well as policy approaches through tax, subsidy and regulatory systems all generate very different outcomes. Equally, housing systems take long periods to adjust to changing incentives so what we observe is not generally the fundamental outcome of these recent pressures but may simply continue to reflect disequilibrium and slow adjustment processes. In order to unravel these relationships, we need to study the evolution of particular housing regimes over time and evaluate the relative effects of the main drivers. For this reason we concentrate on understanding the factors that may have impacted on on landlord and tenant incentives over the last twenty five years.

### 1.3 THE CHOICE OF COUNTRIES FOR THE CURRENT PROJECT

One important aim of this project is to provide lessons from other countries that are relevant to the current situation in Denmark and that suggest what might have to change in order for investment in private renting to increase.

We therefore decided to examine the sector in Denmark and three other countries. These have very different experiences and characteristics, but each has attributes that are relevant to understanding how best to ensure that the PRS meets the needs of households and investors. The four countries chosen were:

- (i) The Netherlands, where the emphasis has been on social rather than private rented housing but which has an integrated system of rent regulation, based on a points scheme which mainly takes account of dwelling characteristics and applies equally to social and private renting. Rents for dwellings in either the social or private sector with points above a certain level were deregulated around 1990, at much the same time as Denmark deregulated rents in new-build private rented units — so the Dutch example may provide valuable transferable experience.
- (ii) Germany, where the large scale and relative strength of the PRS have remained fairly constant over the last 30 years, as has the intentionally stable regulatory framework. Germany is seen to provide the clearest example of a well-operating private rented system. However, the way it functions depends on the specifics of the regulatory and tax/subsidy framework, the conditions under which private renting and other tenures operate and the attributes of dwellings and tenure. Moreover, while the system still works well in less pressured areas, there are now considerable signs of stress in some major cities.
- (iii) England, which, almost alone among the countries included in the first project experienced both massive liberalisation as well as very considerable growth in the PRS (but see the latest evidence from Finland, de Boer et al, 2014; Eerola et al, 2013). In England, much of this growth occurred as a result of changing conditions in other tenures and sector-specific innovations in mortgage finance, rather than directly as a result of deregulation. Most notably from the point of view of this project, the growth in private renting has not apparently led to significant additional investment in new housing supply. Currently, there is considerable policy emphasis on developing a framework to support institutional investment in new, purpose built private rented housing, but this has yet to generate large scale outputs (Bate, 2015).
- (iv) Denmark, where in 1991 there was deregulation of rents at the national level for units built after that date (although considerable complexity at the local level remained). This appears to have had relatively little impact on levels of investment even though there is a growing need for good quality private rented housing, especially for younger and more mobile households in cities.

## 1.4 THE RESEARCH QUESTION

The core question for the research project is:

‘How do incentives and constraints around private rental provision work in different institutional, economic and policy frameworks, and what factors might incentivise investment in private renting and produce an efficient and flexible sector to meet household requirements?’

Answering this involves, first, identifying the economic, financial, public-policy and legal factors that have helped to shape current conditions in the PRS in each country; second, to the extent possible, measuring the relative effects of the different drivers and in particular how they interact with one another to generate current conditions; and third, looking to the future, clarifying what conditions and policies might help to ensure that private renting plays an effective role in meeting housing requirements. We therefore have increasingly focused on understanding what the incentives for new investment in the PRS are and how they operate; why, in all four countries, there appear to be constraints on such investment; and what policies might be introduced to expand output.

Unlike the original project, which compared experience across a large number of countries but did not attempt to make recommendations, the intention in this project is to concentrate on in depth analysis of a small number of countries; to look to the future and to suggest lessons for the Danish system where appropriate.

Unpacking the core question, the research aims to answer five sets of more detailed questions:

- (i) what is the current position of the PRS in each country; how has this position evolved; how have the drivers changed over the last decades; and how can the drivers and outcomes across the four countries be compared? To address these questions we identify the determinants of supply and demand for private rented housing, look in particular at how the tax and subsidy frameworks affect investors, consumers and other tenures; and place the evidence in the broader economic and social context;
- (ii) over time, how have the user costs/rates of return of private rental investment, ownership and consumption changed incentives to invest in and consume private rented as compared to owner-occupied housing? These measures provide a base for understanding the incentives to locate consumption and investment in the different market tenures. Of particular importance here is (a) the scale and role of social renting and demand side subsidies and (b) the other investment opportunities available to investors;
- (iii) what might be changed to increase the supply of new private rented housing, including regulation, tax and subsidy; land availability; and policies associated with other tenures and types of investment? Here we look at both opportunities and barriers to investment;

- (iv) what conclusions can be drawn about the position of the PRS in each country, the role that different policy instruments play in determining that position and its likely future projection?
- (v) finally, what lessons can be drawn about how Denmark might support a better operating PRS?

## **1.5 STRUCTURE OF THE REPORT**

The report is in four sections. The first section (chapters 1 - 3) provides a short description of the attributes of private renting in the four countries and then gives an overview of its post-war development and the major changes that have impacted on that development. Based on these descriptions we are able to set out an implicit model of the factors affecting the scale and role of private renting as a framework for more detailed analysis. Section 2 (chapters 4 - 6) provides a more detailed analysis of how the sector has developed in England, Germany and the Netherlands. Section 3 (chapters 7 - 8) concentrates on a quantitative analysis of the drivers of tenure choice and examines the question of whether major changes in regulation, tax and subsidy in particular have had clear direct effects on the sector. Finally section 4 (chapter 9) brings the material together to identify lessons for the private rented sector in Denmark and particularly the factors that might lead to additional investment especially in new units in the private rented market. A number of annexes provide more detailed information on particular issues.



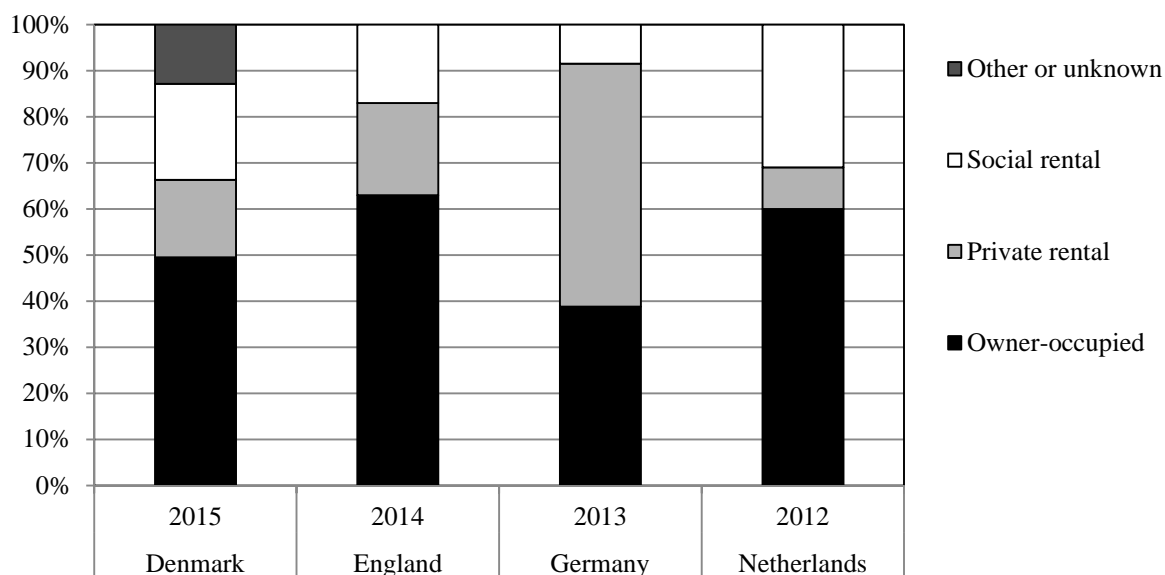
## Chapter 2: The current position of the private rented sector in the four countries

This chapter describes the existing housing tenure structure in each of the four European countries and discusses the current position and role of the private rented sector (PRS). The information comes from questionnaires prepared by country experts, from academic, policy and more ephemeral literature, and from roundtables held in each country (see annex 2). The information is presented in summary form and concentrates on comparing the four countries. More detailed material on policy developments and on the supply of and demand for private renting in the four countries is presented in Chapters 5 to 8 where we analyse the factors that have helped determine the role and scale of the sector in each country.

### 2.1 CURRENT TENURE STRUCTURE

The latest available statistics show that owner-occupation is the dominant tenure in three of the four countries, with the exception being Germany (Fig. 2.1). Germany has the largest PRS (53 per cent in 2013 on a broad definition) while the Netherlands has the smallest (9 per cent in 2012). In England the private rental stock (20 per cent in 2014) is now larger than social rented (17 per cent). In Denmark, on the other hand, the social rental stock is larger (21 per cent vs 17 for private renting in 2015).

**Figure 2.1 Dwellings by tenure in Denmark, England, Germany and the Netherlands**



Sources: Denmark – Statistics Denmark BOL101: Dwellings by region, type of resident, type of dwelling, tenure, ownership, year of construction and ownership; England – DCLG Live Table 104 Dwelling stock: by tenure, England; Germany – Eurostat; Netherlands – Boelhouwer and Priemus (2014) Table 1.

Our previous report for Realdania showed that in three of the four countries the PRS went through long periods of decline since the second world war as a result of regulation, the tax position of landlords and tenants and increasing opportunities in other sectors (Whitehead et al, 2012). Table 2 of that report shows that from the early 1980s to around 2010 the decline was more than a third in Denmark and almost 50 per cent in the Netherlands. Since then the

size of the sector continued to fall in the Netherlands but there has been an upturn in Denmark. England differs in that the upturn started slowly in the 1990s and speeded up from the turn of the century – doubling in size between 2000 and 2014. Finally Germany saw consistent growth in the private rented sector from the early 1980s to around 2010. However there is now evidence of decline as the proportion of owner-occupation increases (while it is falling in the other three countries).

The role of the PRS is affected by its scale but also by the mix of tenures. In general the smaller the sector the more it concentrates on accommodating more mobile and younger households - ie those who are entering the marketplace. Equally the size of the social sector helps to determine the extent to which the PRS accommodates more vulnerable households in that the larger the social sector the more opportunity there is for vulnerable households to gain access to subsidised rental housing.

So for instance in Germany, where the PRS is the majority tenure, the sector accommodates a full range of households. The lack of a significant social rented sector in particular means that poorer households of all types from new migrants to older pensioners are accommodated in private renting. In the Netherlands, on the other hand, with a small PRS and a large social sector, most more vulnerable households can access social housing while those looking for higher quality/valued unit would normally buy. The PRS is therefore mainly a legacy except in shortage areas where more vulnerable households may have to find accommodation in the PRS. In Denmark, the emphasis in the PRS is either on those who have benefited from lifelong security or more mobile households and new entrants to the housing market. In England, the PRS has accommodated younger more mobile households. However it also provides for vulnerable households who cannot obtain scarce social rented housing. Since the turn of the century and especially since the financial crisis the growing sector has increasingly accommodated families and those who would traditionally have preferred to buy a home.

## 2.2 THE ATTRIBUTES OF PRS SUPPLY

In all four countries the PRS stock is concentrated in larger cities. As shown in Table 2.1, at least 30 per cent of dwellings in the countries' major cities are in the PRS except in the Netherlands, where the PRS accounts for only around 15 per cent of dwellings in Amsterdam. In contrast, in the four largest cities in Germany, the PRS amounts to more than 60 percent of the total stock.

**Table 2.1 Spatial concentration of the PRS stock**

	National	Cities with high concentrations of PRS
<b>Denmark</b>	17%	Copenhagen: 20.7%; Aarhus 24.1%; Odense 25.4%
<b>England</b>	20%	London: 27% (Westminster: 40%); Bournemouth: 29%; Brighton & Hove: 29%
<b>Germany</b>	53%	Berlin: 84%; Hamburg: 76%; Sachsen: 67%; Mecklenburg-Vorpommern: 62%
<b>Netherlands</b>	9%	Amsterdam and Utrecht: 17%

Sources: England – 2011 Census of Population; Germany – Mikrozensus Wohnsituation 2011; Netherlands – CBS, WoON 2012; Denmark – Statistikbanken 2015.

In big cities in all four countries, the typical private rented dwelling is a flat (Table 2.2). In England the typical non-urban PRS dwelling is a two-bedroom terraced house while in the three other countries it is still a flat. PRS dwellings in all four countries also tend to be smaller than those in the owner-occupied and social rental sectors. New PRS dwellings are

typically larger than existing ones in three of the four countries. In Denmark for instance the typical new purpose-built private rental flat is in a block located in areas with green surroundings, such as a small park, and has three to four bedrooms and 80–100 square metres of floor space. In England, on the other hand, new purpose-built flats are smaller and have fewer bedrooms than the existing stock.

**Table 2.2 Characteristics of PRS units in Denmark, England, Germany and the Netherlands**

Type of unit	Denmark	England	Germany	Netherlands
Typical (overall)	Flat	London: purpose-built 2-bed flat (40%); outside London: terrace/end of terrace 2-bed house (35%)	60-80 m <sup>2</sup> ; multi-family building	Apartment with less than 3 rooms (75%)
New-build	80-100 m <sup>2</sup> ; block of flats; 3-4 bedrooms	50-69 m <sup>2</sup> , purpose-built flat; 3-4 habitable rooms	86 m <sup>2</sup> ; multi-family building; 2-bedroom	82 m <sup>2</sup> ; apartment; 3 habitable rooms
Existing	60 m <sup>2</sup> ; block of flats; built before 1940; 2-3 bedrooms	70-89 m <sup>2</sup> , terraced house built before 1919, 4-5 habitable rooms	70 m <sup>2</sup> ; multi-family building built 30-40 years ago; 1-2 bedroom	70 m <sup>2</sup> ; apartment; built before 1989; 3 habitable rooms

Source: country questionnaires

One important attribute that tends to distinguish the English PRS from that of other European countries is that each unit in a block of flats is normally sold separately. Dwellings can also readily move between tenures. At the other extreme, in Denmark, the tenure of buildings is generally fixed and difficult to alter, and entire buildings are usually owned by a single landlord. In Germany there may be multiple owners in purpose built blocks although many are owned by a single landlord. In the Netherlands part of the sector consists of small blocks of flats which are usually company owned.

**Table 2.3 Average monthly private and social rents**

	Average private rent	Average social rent
<b>Denmark</b>	€91 per sq metre (2010)	€89 per sq metre (2010)
<b>England</b>	£720/€972 (national); £1,461/€1,972 (London)	£369/€498 (national); £465/€628 (London)
<b>Germany</b>	€1,119 (3-bed apartment in city centre)	not available
<b>Netherlands</b>	€586 (national); €599 (Amsterdam & Utrecht)	€450 (national); €429 (Amsterdam & Utrecht)

Note: Exchange rate based on Bank of England's daily spot exchange rates against Sterling on 5 May 2015. Sources: Denmark: prs [http://www.bvc.dk/SiteCollectionDocuments/Analyser/DREAM\\_rapport\\_2012\\_Huslejeregulering.pdf](http://www.bvc.dk/SiteCollectionDocuments/Analyser/DREAM_rapport_2012_Huslejeregulering.pdf); social dwellings excluding special needs [https://www.lbf.dk/media/33119/husleje-og\\_udgiftsstatistik\\_2010d0a.pdf](https://www.lbf.dk/media/33119/husleje-og_udgiftsstatistik_2010d0a.pdf) England – Valuation Office Agency Private Rental Market Statistics Table 1.7: Summary of property type 'All categories' monthly rents recorded between 1 Apr 2013 to 31 Mar 2014 by Region for England and DCLG Live Table 704 Rents: Private Registered Provider (PRP) rents; Germany – [http://www.numbeo.com/cost-of-living/country\\_result.jsp?country=Germany](http://www.numbeo.com/cost-of-living/country_result.jsp?country=Germany); Netherlands – CBS, WoON 2012

Finally, rent determination differs between the four countries. In Germany there is a 'mirror' system which relates new tenancy rents to those found in the locality while rents within the tenancy are indexed. In the Netherlands rents for social and private tenancies are determined by a points system across the two sectors up to a rent of 700 euros per month. In Denmark rents are regulated with considerable local variation except for properties built after 1991. In

England rents are market determined. In England, the gap between private and social rents is large (Table 2.3), and in London private rents can be three times social rents. In the Netherlands, because of rent regulation, the difference between private rents and social rents is relatively small. The differences lie in the proportion of the private rented sector which is above regulation limits – now accounting for perhaps a quarter of the sector. In Germany no real comparison is possible because of the small size of the social sector. In Denmark there is no comparative data available.

### 2.3 WHO LIVES IN THE PRS?

In Denmark and England, the biggest group of private tenants is younger people under thirty. In the Netherlands, both younger and older people (over 65) tend to be private tenants (Table 2.4). In Germany, private tenants include people at every stage in their housing careers, with an average age of 52.

**Table 2.4 Characteristics of PRS tenants in Denmark, England, Germany and the Netherlands**

	<b>Denmark</b>	<b>England</b>	<b>Germany</b>	<b>Netherlands</b>
Age	Below 30	25-34 (48%)	Average age: 51.9	Below 30 & above 65
Household type	Singles & couples	Singles & couples (50%)	A wide range of households	Singles (51%)
Income level	Income below average	A wide range of incomes	A wide range of incomes	Income below average
Employment	Employed/retired	Employed/unemployed	Employed	Unemployed/retired
Proportion receiving housing allowance	40%	26%	n/a	35%
Average length of occupancy	1.2 years	3.5 years	More than a decade	Over 11 years

Sources: Denmark, 2005, “Den almene boligsektors fremtid”, Bilag 4a, Socialministeriet (2006); England – DCLG (2015); Germany and the Netherlands – Scanlon and Kochan, 2011.

In all four countries there are those that wish to live in the PRS and those who cannot gain entry to other tenures. The proportions differ greatly, however. At one extreme the proportion in Germany wanting to live in private renting is very high, while at the other in England there are many tenants who would rather be in either social renting or owner-occupation. In the Netherlands and Denmark where there are lifetime tenancies there are also numbers of older tenants for whom remaining in private renting has been the obvious choice.

Except in Germany, private tenants are disproportionately likely to be:

- Smaller households: single persons and couples without children.
- Households with below average incomes. However, the recent expansion of the PRS in England has enabled it to accommodate more middle-income households (Ball, 2011; Whitehead et al, 2012). Equally there is a proportion of mainly more mobile better off households in the non-regulated part of the sector in the Netherlands, especially in Amsterdam.
- Economically active, in part because of the disproportionate number of younger and more mobile people in the PRS. However, in Denmark and England, many private

tenants are unemployed with large concentrations of students while in the Netherlands, they are more likely to be either unemployed or retired.

- Claiming housing allowances – 35 per cent of private tenants in the Netherlands and 26 per cent in England claim housing allowances. Both countries have social rented sectors that accommodate large proportions of the more vulnerable households. However the private rented sector also accommodates those just coming into the housing market and those in high demand areas who cannot access social housing.
- Employed/retired in contrast to the other three countries, Germany's PRS accommodates a wider range of household types with different income levels – in part simply because it is the majority tenure and in part because there is a very limited social sector to accommodate poorer households. Overall, private tenants in Germany are more likely to be employed and would like to stay in their home as long as they can - very different from the younger, more mobile sector which dominates in the other countries.

## 2.4 WHO INVESTS IN THE PRS?

The supply of private rental dwellings in the four countries, as in other countries around the world, is dominated by small individual landlords, not institutions. Small providers can be 'amateur'/non-professional or professional individual landlords (Oxley *et al.*, 2010). Amateur landlords usually own only one or two dwellings, while many professional individual landlords set up private housing companies to buy either new build properties or to buy older existing housing – in England this will often be ex-social housing. There are some larger companies that specialise in private rental property but these are relatively rare. The Netherlands has the highest proportion of company landlords who have been in place for decades and are now often looking to leave the sector. There has been very little new institutional investment in the last few decades. In Germany some of the largest companies have purchased their whole social sector housing stock from local authorities. Institutional investors, such as insurance companies, pension schemes, sovereign wealth funds or social security schemes, do invest in Germany and to a much smaller degree in the Netherlands. They have also begun to enter the market in England, but they tend to operate in particular parts of the rental market and have small overall market shares. Even in Germany, financial institutions own only 12 per cent of the housing stock (Eichholtz, *et al.*, 2014). In Denmark, institutions own about 7 per cent of the PRS (Anderson, 2010).

### *Inflows and outflows of existing units*

Given that the research question concentrates on the incentives to supply and to live in private renting, it is important to understand the flows into and out of the private rented sector in each country.

Table 2.5 shows the sources of existing private rental dwellings in the four countries. In England, during the long decline in the sector PRS units were either demolished or went to owner occupation. Since the 1990s much of the stock that has entered the PRS has come from owner occupation particularly since 2007 but also in other property slumps (Crook and Kemp, 1996; Whitehead and Scanlon 2015). Properties have also come from the Right to Buy (a policy that allowed sitting social tenants to buy their homes at large discounts from 1980; over time significant proportions have then been sold on into private renting (see eg Sprigings and Smith, 2012; Copley 2014). Since the turn of the century there has been an

increasing supply of good-quality PRS dwellings under buy-to-let mortgages (Thomas, 2014).

In Germany, much of the PRS is purpose-built rental stock– in some instances, originally built as time-limited social housing before reverting to the private sector or sold by local authorities to private landlords. The sector has also attracted some newly built units and, because properties can transfer between tenures freely. It also includes properties that have been owner-occupied, although the proportion is small.

In Denmark, dwellings when they are built have a defined tenure so a large proportion of the existing stock has been purpose-built as rental units. Any building with more than three units is likely to have been purpose-built for the PRS. Even so there has been some transfer from and indeed losses to the owner-occupied sector. Since 1991 the rents on newly built privately rented properties can be set by negotiation – which has resulted in some additional investment.

The picture in the Netherlands has been one of almost continuous decline, with properties transferring to owner-occupation or being demolished. Even so some owner-occupied housing has transferred to private renting mainly, in higher demand inner areas. Small numbers of social sector units have also transferred, sometimes via tenant purchase and re-sale.

It is important to note that following the global financial crisis, there were larger flows from owner occupation into the PRS in Denmark, England and the Netherlands where owner occupiers were unable to sell their properties at desired prices and became ‘reluctant landlords’ or ‘property slump landlords’ instead.

Thus, across all four countries a significant proportion of dwellings entering the PRS have been existing dwellings rather than new-build. In addition there is the long standing stock (often much depleted by sale to other sectors and slum clearance) which is mainly made up of dwellings that were originally purpose-built for private renting (whether legally or market determined) before the second world war.

**Table 2.5 Sources of private rental dwellings in Denmark, England, Germany and the Netherlands**

	Previously owner-occupied	Previously social renting	New-build private	Purpose-built PRS
<b>Denmark</b>	xx		x	xxx
<b>England</b>	xx	xx	x	x
<b>Germany</b>	x	xxx	x	xx
<b>Netherlands</b>	xx	x		xxx

Key: xxx = many  
 xx = some  
 x = a few

### *The current role of new-build*

New-build dwellings, either purpose built for private renting or simply purchased by landlords, generally account for a relatively small part of overall housing output. In England, new purpose-built private rental dwellings are rare. A small proportion of new rental properties may be created by renovation or conversion of former single-family properties into flats. The vast majority of new build private renting, however, comes from purchase of new units which could equally have been purchased by owner-occupiers. Buy-to-let interest only

mortgages have played an important role in expanding the proportion of new build going into the sector Housing associations have also become increasingly involved in providing market rental housing since the financial crisis, in part to cross-subsidise social sector provision. (Walker, 2014).

In Germany new rental units may be purchased by owner-occupiers or by private landlords, either as blocks of flats or singly. The flow of new housing into private renting continues but has fallen over the last few years.

There has been almost no new-build provided in the PRS in the Netherlands for many years. The fact that higher valued units are not regulated has not significantly changed this position.

## **2.5 CONCLUSIONS**

The private rented sectors in these four countries are diverse in their size – ranging from under 10 per cent to over 50 per cent – and composition. Patterns of growth and decline are also specific to each country. The extent to which private renting is seen as a mainstream tenure varies greatly – with private renting seen as the ‘normal’ tenure for all types of household in Germany; while in other countries with smaller sectors it tends to be concentrated more on younger, more mobile but also poorer households.

Nevertheless, there are similarities in terms of the location of the private rental stock (mainly in cities and large urban areas) and the profile of private landlords (overwhelmingly individuals rather than large companies or institutions). The country that stands out as different here is the Netherlands where longstanding company landlords are an important part of a declining sector. Finally, growth and decline in the sector comes more from shifts of properties to and from other tenures than directly from new build. This appears to be true even in Denmark which designates the tenure of new build properties.

## **Chapter 3: How the private rented sector has developed in the four countries**

This chapter looks at how the scale of private renting has changed over the decades. It places the private rented sector in an understanding of the wider housing system and traces some of the key political changes that have affected the supply and demand for private renting in the four countries. These key changes can be divided into those that affected the PRS directly – including in particular the regulation of the sector, taxation of rental incomes and subsidies to landlords and tenants – and those that affected it indirectly, such as new policies directly affecting other tenures.

### **3.1 THE CHANGING SCALE OF PRIVATE RENTING**

We start by looking at how the size of the PRS has changed over the last decades. Around 1950, the PRS was the majority tenure in England (53 per cent) and the Netherlands (60 per cent). In both West Germany (48 per cent) and Denmark (40 per cent) it was the largest although not the majority tenure. At that time, there was heavy regulation in all four countries, with rents held usually at pre-war levels. This was associated with rapid decline in three of the four countries, England, the Netherlands and Denmark, as other tenures became more accessible. However in West Germany there had been little change in the relative importance of the sector even though there was a period of almost complete de-regulation, followed by the introduction of a more flexible regulatory system which allowed some managed rent adjustment to market pressures. Table 3.1 shows how the importance of the PRS has changed from around 1980 onwards. The position is very different between the four countries. The reunified Germany has seen an absolute and proportional expansion during the 40 year period (although there are now signs of decline in some cities). At the other extreme, the Netherlands shows continual decline to below 10 per cent of the total stock, at least to 2012 (the year to which the latest data apply). In Denmark, the PRS continued to decline but relatively slowly. The pattern of change in England was totally different, with declines in the 1980s, limited increases in the 1990s and rapid expansion since the turn of the century especially after 2008 – resulting in a sector that is twice the size it was at the turn of the century.



**Table 3.1** Changes in tenure structure (%), 1980–2015

	Denmark			England			West Germany			Germany		Netherlands			
	1980	1990	2000	2015	1981	1991	2001	2014	1982	1993	2001	2013	1980	1990	2012
Owner-occupied	52	52	51	50	59	68	70	63	40	42	41	39	42	45	60
Private rental	22	18	18	17	11	9	10	20	45	48	49	53	17	15	9
Social rental	14	17	19	21	29	23	20	17	15	10	6	9	41	40	31
Other or unknown	9	9	5	13							4				
Total number of dwellings (000s)	2,109	2,353	2,489	2,628	17,912	19,671	21,207	23,372				39,268			7,107

It is the reasons for these divergent trajectories that we are looking to clarify in order to understand the relative economic benefits to landlords and tenants as well as the constraints they have faced and thus the drivers that have generated these very different patterns of change.

### **3.2 PRIVATE RENTING WITHIN THE WIDER HOUSING SYSTEM**

In looking to understand how the PRS has developed over the post war period we need to set that development in the broader context of housing systems. To this end this section identifies four main overlapping stages in the development of housing markets across the four countries and the place of private renting in this changing landscape, stressing in particular the changing role of regulation, factors affecting tenure mix and the relative importance of new build as compared to the existing stock. The four stages are very much a stylised picture based on European trends – the specifics of each country differ both in timing and the relative importance of different drivers.

#### *Stage 1: New housing supply together with strong regulation*

For a long time before the second world war, the PRS was the dominant housing tenure in all four countries, as in much of the rest of Western Europe. During and after the second world war, there was strong government intervention, with policy directed towards massive subsidies for housing construction and large scale house building programmes. At the same time, strict controls on rents and security of tenure were maintained.

After the war, the general emphasis in all four countries was on trying to deal with the backlog of housing supply. There had been almost no building during and immediately after the war. There were massive shortages and many homes were in very poor condition. Given these shortages, the immediate need was seen to be to protect households from excessive rent increases and eviction – generating little incentive to invest in new supply. There was virtually no new purpose built construction for the PRS in any of the four countries. In Denmark, England and the Netherlands, extensive subsidies were given to the public or non-profit social rental sector. In West Germany, subsidies for new housing construction were not only available to public-sector and non-profit housing companies but also to private landlords and owner-occupiers equally. After an agreed period, the subsidised dwelling units could be transferred into the private market, which formed the basis for a PRS. In England and the Netherlands, particularly strong emphasis was also placed on the owner-occupied sector in making up the post-war housing shortage. Because of the generous subsidies, both the owner-occupied and the social rental sectors grew strongly in the four countries. Heavy rent regulation limited the incentives to invest in the PRS while lifetime security of tenure meant that landlords who wished to disinvest found it hard to do so. Within the rental sector, the share of social housing was larger than the PRS.

Compared with the subsidy for owner-occupation and social renting, financial support for the PRS was very small and consequently, new construction in the PRS was relatively limited. While strong tenure security limited outward movement of privately rented housing stock, there were increasing incentives for private landlords to sell their dwellings either to the sitting tenants or on the open market when they became vacant. There were also programmes of slum clearance which usually involved privately rented dwellings. Thus not only did the proportion of private rented dwellings in the housing stock decline, but the absolute number of private rented dwellings also fell in all four countries.

## *Stage 2: Improvement in the housing stock and the growth of homeownership*

Once the housing shortage had largely been eliminated, government policy was directed, to an increasing extent, towards improving the quality of the existing housing stock in addition to new construction (Boelhouwer and van der Heijden, 1992). Increasing attention was devoted to the old, poor-quality private rental dwellings in inner cities. At first, policies concentrated on demolition and rebuilding (slum clearance) although later the emphasis moved towards renovation. In both cases the investment was often accompanied by a change in tenure to social rented housing particularly when replacement was involved and to owner-occupation when properties fell vacant and could be renovated by the new owner. Both clearly resulted in decreases in the size of the PRS (Harloe, 1985). The relative emphasis on social versus private improvement depended heavily on taxation and subsidy systems – with Germany providing a more neutral approach and the other three countries concentrating more on social renting.

In addition to the rehabilitation of the existing stock, governments began to relax the rules on setting rents in the PRS. As shown in Table 3.1, the extent of rent deregulation, the pattern of changes and their timescale were all very different in the four countries and this has continued over the whole period of analysis. England started the process first moved slowly but inexorably towards complete decontrol by 1988. West Germany took the strongest decontrol measures in the early 1960s but a decade later moved to what is called third generation rent control which has been maintained ever since. Denmark and the Netherlands have maintained controls for most rental properties but introduced exceptions aiming to increase investment.

England was the first country to remove rent controls for dwellings above a certain rateable value in 1954, but rent control was resumed in the form of ‘fair rents’ from 1965. It was not until 1988 that private rents were fully deregulated. In West Germany, rents in so-called ‘white districts’ (regions in which the housing shortage was below three per cent) were deregulated incrementally from 1961 onwards. Rent control was finally abolished in 1971 but was immediately replaced by a more sophisticated form of rent stabilisation which affected all privately rented tenancies. In Denmark and the Netherlands the very strict rent regulation continued until 1991 and 1989, respectively, when deregulation of newly constructed rental units was introduced in Denmark and the upper end of the market was deregulated in the Netherlands (see Whitehead et al, 2012 for details). Linked to the issue of rent regulation was that of security of tenure – and therefore both the position of existing tenants and of those entering or moving within the sector.

What should also be noted is that at this stage there was relatively little movement to deregulate housing finance markets, so only well-off households with a good savings record could expect to obtain a mortgage to purchase their own home and development finance came mainly from banks that saw housing development as relatively risky. Investment was thus framed mostly by local authorities or by government subsidy regimes.

**Table 3.1 Changes in rent regulation in Denmark, England, Germany and the Netherlands**

Period	Denmark	England	Germany	Netherlands
1950s		1954: rent decontrol for dwellings over a certain rateable value		
1960s	1966: major changes in rent legislation. Rent to be determined in relation to the value of the rented dwelling		1961: rent deregulation in some lower demand districts	
1970s	1975: major changes in rent regulation -cost related rent introduced		1971: rent control abolished but a local comparable rents system introduced	
1980s		1988: all rents to be market determined and introduction of assured shorthold tenancies for new leases		1989: rent deregulation at the upper end of the rental market for both the PRS and social rented sector
1990s	1991: removal of rent control for dwellings constructed after 1991; 1996: rents allowed to increase to the 'value of the rented dwelling' when major improvements completed			
2000s	2004: market rents allowed for new roof-top apartments in rented buildings			
2000s			2002: introduction of Rent Table and cap on rent increases	
2010s			2011: reduction of annual rent increases; 2015: additional constraints on rent increases including rent brake in regions with a tight rental market	2010: higher rent increases for higher income tenants; 2011: maximum rent increases raised in 10 areas where housing supply is scarce; 2014: Rent freeze on regulated tenancies for three years

### *Stage 3: Reducing and rebalancing housing subsidies*

As absolute shortages were overcome and the European Union increasingly emphasised fiscal constraint, nearly all countries in Europe started to reduce their public spending on housing investment (Turner and Whitehead, 1982). At the same time, as incomes rose, homeownership began to grow, especially as it was promoted via direct and indirect tax incentives. However, from 1970 fiscal concessions to owner-occupiers began to be cut back in some countries even where there was often continued emphasis on expanding the sector by other means. Subsidies were shifted away from housing construction and social housing providers towards rent subsidies to low-income tenants in the PRS and social rented sector and sometimes also to low-income owner-occupiers. This shift from supply subsidies to

income-related subsidies benefitted private tenants who became eligible for support. All of these pressures helped to shift the tenure mix, usually towards a greater emphasis on private provision.

In some ways the German experience was rather different, in part because of the pressures of reunification. Large-scale subsidies for social housing construction were reintroduced in 1989 but were terminated in the early 2000s with some subsidies shifted to the modernisation of the existing stock. A one-off eight-year grant for first-time buyers to construct owner-occupied housing was also introduced in 1995 but withdrawn in 2005.

In England, the ‘Right to Buy’ was introduced in 1980 which required local authorities to sell their social rental dwellings to sitting tenants at a discount and resulted in nearly two million units being transferred to owner-occupation. Public funding to social housing has been cut dramatically since 1988. In West Germany, indirect subsidies via the tax system (mortgage interest deduction and imputed rent taxation) were reduced, and the tax privileges for non-profit housing companies were abolished in 1986. In the Netherlands, operational subsidies to social rented housing and housing construction were terminated in 1995, and the tax subsidy to owner-occupation was reduced significantly in 2001. In Denmark, unlike the other three countries, supply subsidies to social housing remain an important part of current government support for housing.

Even though the emphasis in national policies was moving towards privatisation, the size of the PRS continued to decline during the 1970s and the 1980s except in West Germany. The volume of new production in the PRS remained small across all four countries. In West Germany, however, the PRS grew as a result of the transfer of previously social rented dwellings as the subsidy based rent restriction period ended. However, the subsidy to new construction accompanied by rent restrictions has been steadily decreasing, replaced by subsidies and tax breaks to encourage the renovation of existing buildings (Fitzsimons, 2014).

#### *Stage 4: Housing pressures and the role of the PRS as a source for affordable housing*

Partly because of the reductions in government funding for housing construction and particularly social housing, there have been shortages of sub-market housing in all four countries and, except in Germany, increasing pressures on house prices and affordability. Even in Germany, regional housing market pressures have begun to appear in urban regions with strong economic growth.

With continuing cuts in public expenditure on social housing, the PRS in Denmark, England and the Netherlands has taken on an expanded role in the housing system, supplementing the role of social housing in accommodating low-income households. This was made possible by the availability of income related subsidies across the rented sectors. More generally new entrants to the housing market whether students and other young people or migrants (both expanding groups) mainly rely on the private rented sector for accommodation – so there is increasing pressure for additional supply.

The 2008 global financial crisis pushed housing markets across Europe into recession with impacts on prices and investment. Even in Germany where the housing market remained relatively stable, housing construction declined. Because of the growing demand for private renting, political pressures from existing tenants have pushed governments in Germany and the Netherlands to strengthen their regulations in at least parts of their PRS (see Table 3.1).

Germany has increased its rent control and rent increases in high pressure areas. The Netherlands has relaxed its very strict rent regulations so that higher-income private tenants pay higher rents, but the government are now looking to reintroduce rent control for the lower segment of the private rental market. In contrast, the focus of governments in Denmark and England has been on special measures to stimulate new investment in the PRS, particularly investments from financial institutions.

### 3.3 DEVELOPMENTS IN LEGISLATION AND HOUSING POLICIES IN FOUR COUNTRIES

The comparison of the four countries set out above suggests that there are both similarities and dissimilarities in how governments have treated the PRS. It also suggests that how the PRS's role has changed can be as much an outcome of policies with respect to other tenures as it is to how the PRS itself is treated. To clarify some of these issues we need to look more closely at government intervention across tenures. In this section we identify some of the most important legislative and policy changes across housing systems which impacted directly and indirectly on the PRS in each country.

#### *Denmark*

Table 3.2 highlights the legislation that has impacted on the role of the PRS in Denmark over the last four decades. The most notable policy is the 1975 Housing Regulation Act, which introduced cost-based rents for private and social landlords – and made it impossible for private landlords to increase rents in the face of increased demand. This made investment in the PRS unattractive. Later, rental property built since 1991 was exempted from national rent controls, creating two separate private rental markets.

**Table 3.2 Timeline of legislation and government initiatives affecting the PRS in Denmark**

	<b>Events with direct impact</b>	<b>Events with indirect impact</b>
1960s	1966 housing agreement allowed some rent adjustment Housing benefits introduced	Government subsidies to new house building Mortgage interest tax relief for home ownership
1970s	1975 Housing Regulation Law allowed cost-based rents in private and social rented sectors	Tenant cooperative housing associations to buy multi-unit buildings enabled 1975: Phased out subsidies to social housing construction
1980s		1987 tax reforms – regulated investment in housing and demand. Reduced the value of deductible interest payments from 73% in 1987 to 52.2% in 1993
1990s	All dwellings constructed after 1991 exempt from rent control 1996 allowed rent increases for modernised PRS units	1994–99 tax reforms reduced the value of deductible interest payments from 52.2% to 32.2% in 2001
2000s	2002 pension funds and insurance companies allowed lower corporation tax on PRS income 2004: New roof-top apartments on existing rented buildings exempt from rent controls	2000 imputed rent taxation of owner-occupiers abolished and replaced by a real estate tax

Throughout the last decades, the Danish housing market has been heavily regulated. It has also been subsidised through indirect tax subsidies, subsidised construction, housing allowances and rent regulation. There has been a gradual transition away from support for housing supply towards support for households, with greater use of housing allowances and less use of subsidies to construction, for example, the abolition of subsidies to construct new co-operative dwellings. To encourage investment in private rental housing, the government

increased tax incentives for pension funds to invest in private rental properties, although there has been relatively little impact (OECD, 2006).

### *England*

Table 3.3 sets out the major legislative and housing policy changes that have impacted on the role of the PRS in England since the 1960s. The most notable ones are the Housing Act of 1988 which included full rent deregulation of all new tenancies and the creation of the Assured Shorthold Tenancy (AST) which gave a minimum of only six months security and the introduction by the finance industry of buy-to-let mortgages in the mid-1990s which enabled purchasers to obtain an interest-only mortgage against the rental income stream. The first provided a framework that potentially enabled new investment in the sector while the second provided an easily accessible funding mechanism.

An important consequence of the Right to Buy has been that, although initially these properties were owner-occupied by the sitting tenant, thereafter they might be sold on into private renting. This has been an important element in the expansion of the PRS. During the period from 2001 to 2011 the size of the private rented sector doubled mainly as a result of transfers of properties from owner-occupation and social renting together with a proportion of new build. Rising house prices and worsening affordability from the turn of the century fuelled demand for private renting from those unable to access owner-occupation while landlords invested in the PRS in expectation of large capital gains. At the same time, homeless families and individuals who would have expected to enter social housing in the past were increasingly housed in the PRS with the aid of housing benefit.

**Table 3.3**      **Timeline of legislation and government initiatives affecting the PRS in England**

	<b>Legislation and government initiatives with direct impact</b>	<b>Legislation and government initiatives with indirect impact</b>
1960s	1965 Rent Act introduced fair rents in the unfurnished PRS	
1970s	1974 Rent Act extended to the furnished PRS; 1974 introduction of housing allowances for private tenants	1972 Fair Rent extended to the social rented sector and the introduction of rent rebates to council tenants: 1975 Removal of Fair Rent in council houses: 1977 Housing (Homeless Persons) Act Liberalisation of housing finance
1980s	1980 Housing Act; Assured tenancies 1988 Housing Act; Assured shorthold tenancies 1988 Business Expansion Scheme supporting individual investment	1980 Right to Buy 1988 ; Mixed funding regime for housing associations; 1989 Large scale voluntary transfers: From 1980 liberalisation of mortgage finance
1990s	1996 buy-to-let mortgages: (non- government initiative)	Mortgage tax relief set to decline rapidly
2000s	2004 Licensing of houses in multiple occupation, 2005; Real Estate Investment Trusts: 2008 Local Housing Allowance:	2000 Removal of mortgage interest relief for owner-occupiers ;
2010 -	2013/2014 Build to Rent and guarantee initiatives for new build in the PRS 2013 Restructuring welfare support - universal credit Introduction of Build to Rent and guarantee for funders 2015 Tax relief reductions for PRS, particularly buy-to-let	2011 Affordable Rent regime in the social rented sector: Local authorities enabled to build new council housing Capital subsidies for social housing reduced  2013 and 2015 Subsidies to new build for owner-occupation

## Germany

Table 3.4 sets out the major legislative and housing policy changes that have impacted on the role of the PRS in Germany. Rents were initially controlled at pre-war levels, which reduced the incentive to invest in the sector. In 1953, the government allowed landlords to deduct depreciation from rental incomes for tax purposes, providing a clear incentive for private landlords. The severe post-war rent controls were replaced with a rent system based on the rents of comparable properties in 1971 so that by the mid-1970s, landlords could charge rents that were close to the local average and close to notional market levels. Tenants benefitted from the fact that under normal conditions tenancies were indefinite.

**Table 3.4** Timeline of legislation and government initiatives affecting the PRS in Germany

	Legislation and government initiatives with direct impact	Legislation and government initiatives with indirect impact
1960s	1965 housing allowances for low-income households	
1970s	1971 Tenants' Protection Act abolished rent control and introduced the comparable rents system	mortgage interest reduction and imputed rent taxation
1980s	1981 increase in tax deductions for depreciation	1985 removal of subsidies for new social housing construction; termination of tax exemption for non-profit housing companies; after 1989 reunification resumption of large scale subsidies for social housing construction
1990s		1995 introduction of <i>Eigenheimzulage</i> , a one-off grant paid over 8 years for first-time buyers to construct owner-occupied housing
2000s	2001 Tenancy Reform Act distributed rights and responsibilities more equally between tenants and landlords 2001 Housing Subsidisation Act introduced maximum rent and rent increases 2004 cut back on the rate of depreciation deduction	2005 termination of <i>Eigenheimzulage</i>
2010s	2011: additional restrictions on rent increases 2015 Rent brake (introduced the possibility of rent ceilings)	

Also important for Germany was the large scale construction of rental units which, in exchange for subsidy, were rented as social housing, usually for an initial fifteen year period. Thereafter these properties when they fell vacant could be let at market rents, although local authority owners usually maintained the properties at below market levels. There were also subsidies to allow owner-occupiers to add a 'granny annex' which could be let at market rents. In addition, the Tenancy Reform Act in 2001 distributed rights and responsibilities more equally between private landlords and tenants, by limiting maximum rent increases and specifying notice periods more consistently.

Recently, there have been strong political pressures to tighten rent control in some cities where rents (and house prices) have been rising rapidly. First, in 2011, the capping limit of annual rent increases was reduced from 20 per cent within three years to 15 per cent. Since then there have been moves further to restrict rent increases. For new tenancy contracts, a new law, the so-called rent brake (*Mietbremse*), came into force in mid-2015 which enabled a rent ceiling to be introduced such that the initial rent cannot exceed 10 per cent of the reference rent (*Mietspiegel*) in the locality. There is an exemption for newly constructed dwellings. The decision to enforce these new rent caps is made by the *Länder*. So far they



have only been introduced in Berlin, Hamburg and a number of cities in Bavaria. About four million rental dwellings are located these areas (Cornelius and Rzeznik, 2014).

### *The Netherlands*

The housing sector in the Netherlands has long been shaped by government intervention in the areas of housing, urban renewal and physical planning. The long history of public involvement in the housing market and of highly interventionist housing policies has contributed to the growth of homeownership and the development of a large social rented sector (Høj, 2011).

Table 3.5 lists the major legislative and housing policy changes that have impacted on the role of the PRS in the Netherlands. Importantly, large subsidies were available to owner occupiers and housing associations for new construction. Home ownership has also enjoyed mortgage interest tax relief at the marginal tax rate. Private landlords did not receive equivalent subsidies or tax breaks and were taxed at investment rates. Strict rent regulation has kept rents well below market levels since 1955 except where demand is declining. The PRS is subject to exactly the same form of rent controls and security of tenure as the social housing sector. In both sectors rents on properties where the points system that determines rent would result in a rent above 700 euros per month are now deregulated.

**Table 3.5** Timeline of legislation and government initiatives affecting the PRS in the Netherlands

	<b>Legislation and government initiatives with direct impact</b>	<b>Legislation and government initiatives with indirect impact</b>
1960s	deregulation of control over initial rents and gradual rent relaxation from 1967	
1970s	1971 re-regulation of initial rents based on points system and rent increases determined annually by Parliament. 1970 Housing allowances introduced for both private and social rented sectors	
1980s	1989 deregulation of rents in the upper end of the rental market in both private and social sectors	1980 mortgage interest relief for homeowners to promote homeownership
1990s	1997 Housing Allowance Act increased rent subsidies to tenants	1992 ended subsidies to housing associations for operational deficits 1996 Grossing Operation: ended subsidies for social rented sector overall National Mortgage Guarantee system to promote homeownership
2000s		2001 some limitation of mortgage interest deductions
2010s	2010 a large rent increase for tenants in the highest income-tax bracket; increase in maximum rents: 2011 Quality added to points in high demand areas 2012 Landlord levy on rental properties with a regulated rent at 2% of rent rate; 2014 three year rent freeze on rent controlled properties	2013 National Mortgage Guarantee system modified 2011 new limits on mortgage: loan to value ratios and use of the interest-only mortgages restricted

In 2010, the new coalition government of Conservatives and Christian Democrats started to shift the Dutch housing system more towards the market with a social rental sector focused more closely on those in need. When the government fell in April 2012, the only proposal that had been accepted by Parliament was for rent controls to take more account of the popularity of dwellings: in areas where dwellings are scarce a number of quality points will be added allowing for higher rent levels once new tenants move in. However, a new

Landlord Levy was also introduced in September 2012 on rental properties with a regulated rent. This further discouraged commercial residential real estate investors from building new rental properties (Boelhouwer and Priemus, 2014). In 2013, a change in regulation was introduced to allow landlords to increase rents for higher income tenants and latterly a freeze on regulated rents until 2017. These changes have the potential to shift additional properties into the market segment by undertaking improvement and should in principle increase incentives to supply above that level. (Haffner et al., 2014).

This analysis suggests that there have been very large scale changes in government housing policy in all four countries. In the PRS it is not just a matter of rent regulation and security of tenure but also includes tax incentives to support investment and housing allowances to enable tenants to pay the rent. The social sector has provided for large proportions of mainly lower-income households which clearly impacts on the potential role of the PRS. In the early years direct government investment in social housing occurred in all four countries – but there are considerable differences in how the role of social housing has evolved. At one extreme much of social housing has become privately rented over time in Germany and there is little or no new investment in the social sector. In the other three countries there have been significant reductions in available subsidies and in the UK in particular policies to transfer stock to other tenures. But possibly the most important factor affecting the incentives of both landlords and tenants to be in the PRS has been the tax and subsidy treatment of owner-occupation together with more general financial deregulation enabling households to buy.

Both the extent of policy change and its timing has differed greatly between countries. As table 3.1 showed, modifications in rent regulation have taken place at very different times across the four countries and in some cases there has been deregulation and subsequent re-regulation. Equally all countries have introduced housing allowances but at very different times and covering varying groups of households. The big ‘external’ issues relate particularly to the changing (usually declining) levels of support for new investment in social housing and to the package of tax and sometimes subsidy benefits available to owner-occupiers. These differences all suggest that we should observe different patterns of growth and decline in the PRS across the four countries as well as different incentives to expand or reduce investment in new PRS dwellings.

### **3.4 ATTITUDES TOWARDS THE PRS**

Government attitudes to private renting depend significantly on the fundamentals of each country’s political economy. Denmark has been described as being a ‘Nordic socialist state’ (Abrahamson, 2003) with egalitarian objectives and an expectation that housing would play a key role in social welfare. The political approach has put the emphasis on regulation and tenant welfare but also on local government powers to shape the market. The outcome has been continuing emphasis on the provision of social housing, continuing regulation of private renting together with generous income related support and a complex web of local regulations which impact on incentives to invest in the sector differentially across the country.

Post-war England had a similar, although more centralised, approach but this was modified very significantly with the introduction of a liberal (some would say neo-liberal) government in the 1980s. The result was the privatisation and deregulation of much of the economy, including the PRS, but a continued commitment to ensuring minimum standards through

demand side subsidies available across the rented sector. Wider deregulation particularly of the finance market together with an emphasis on consumer choice has pushed demand towards owner-occupation while public expenditure cutbacks, transfer policies and greater targeting of subsidies have reduced the capacity of the social sector to provide (Berry, 2014; Whitehead 2014; SAGE ).

The model in West Germany has traditionally been described as corporatist (Esping-Anderson, 1990) while that in communist East Germany saw housing as very much part of the social wage involving low rents and strict allocation policies. Since reunification strong regulation with respect to housing finance has limited opportunities to enter owner-occupation even though there have also been periods of subsidy to expand such investment. Equally there has been an acceptance that although social housing investment was necessary to expand total supply that investment could be effectively managed by the private sector. As a result private renting has been the obvious option for both households and investors.

The Netherlands is seen as having a hybrid of social-democratic and conservative models of government (Kammer et al, 2013). Within housing this has generated a neutral regulatory framework for the private and social rented sectors but a generous tax relief system for owner-occupiers. Equally there are government guarantees helping to finance both social and owner-occupied housing and financially powerful housing associations.

It is also often argued that attitudes towards the PRS are important in shaping its role in different countries: the English maxim that ‘an Englishman’s home is his castle’ is said to evidence a strong national preference for owner occupation, as compared to Germany where people are perceived to be happy to rent privately for the long term. However, repeated attitude surveys show that German households do indeed aspire to home ownership, which raises the question of why the homeownership rate is so low (Kohl, 2014).

Except in Germany, where attitudes have been positive throughout the period, the attitudes of national governments to the PRS have shifted over the last few years from broadly negative or almost uninterested to positive, as the sector is now seen as a potential source of housing, particularly after the global financial crisis. There is increasing emphasis on promoting institutional investment into the sector in England, Denmark and the Netherlands.

However, there is little evidence that attitudes of the general population have not changed significantly, despite the growing demand for private renting. In Germany and the Netherlands in particular, populist pressures around rising rents have led to increasing rent controls in both countries and there are similar pressures in England especially in London.

### **3.5 CONCLUSIONS**

To some extent the housing systems in each of the four countries have passed through similar stages of development, although particular policies were implemented at different times and trajectories have been significantly different, especially with respect to private renting. From the reconstruction period after the second world war to the 1970s, the PRS shrank in almost all countries across Europe except Germany. This contraction was associated with weak effective demand and the sector’s relative disadvantage vis-à-vis the subsidised social rental sector and the tax advantaged owner-occupied sector. However, the demand for private renting has been growing recently partly because of increasing affordability problems, the impact of the global financial crisis on access to mortgage finance and the consequences of

the recession on both individual incomes and public revenues. New financial incentives to stimulate investment in the PRS have been introduced in a number of countries and there is pressure across Europe to try to promote institutional investment into new supply.

It is also clear that rent deregulation is not a sufficient condition for the stimulation of private investment in the form of either new construction or renovation and repair in the PRS. Moreover, where regulation remains strong it may well be constraints on movement out of the sector and the lack of other options which help to maintain the supply of private rental housing. Thus, while in principle the potential impact may seem clear, it will usually be misleading to isolate the impact of a single policy initiative. The context in which a policy or programme is implemented and its dynamic interaction with other policies will have a critical bearing on observed outcomes.

## **Chapter 4: Drivers of change in the scale and role of the English private rented sector**

The post war English housing system has been typified by four main periods:

- the first under both Labour and Conservative governments, when the emphasis was on increasing overall supply, particularly through subsidies to local authorities to build housing to be let at sub-market rents and tax reliefs to support home ownership;
- a period (running from the election of the Conservative government in 1979 to the mid-1990s) when the emphasis shifted towards privatisation of the social sector and liberalisation of mortgage markets enabling the rapid growth of owner-occupation;
- a third period from 1997 - 2010 when owner-occupation became less accessible and private renting became more important; and
- a final period since 2010 in which government started to support new investment in the private rented sector more directly.

Even within the first period there was some policy directed at improving the operation of the private rented sector, notably through regulatory change. In the second period decontrol was completed. But it was not until market conditions changed in the third period that significant growth in the sector occurred and was then followed by government initiatives to expand new supply.

In this chapter we trace the political and economic changes that affected the supply of and demand for private renting in England in these four periods, with particular emphasis on the legislative and housing policy changes that have helped to determine the current role of the private rented sector (PRS) in the English housing system. The final section clarifies that current position.

### **4.1 POST-WAR - 1979: THE DECLINE OF THE PRS**

The immediate objective of post-war housing policy, starting in the early 1950s, was to supply the maximum number of houses in the minimum period of time to solve the severe shortage problem (Wendt, 1962). The Labour government put emphasis on local authorities building social rental housing with the aid of government subsidies and low-interest-rate loans across the country. Local authorities produced more than 2.9 million housing units in the two decades after the War. This housing was built to high standards and was aimed mainly at low- to middle-income households who could afford the quite high rents charged (Lowe, 2011, p.50). Much was in suburban and greenfield areas and consisted of terraced and semi-detached dwellings with gardens. There was an increasing emphasis on urban slum-clearance programmes (implemented through large-scale demolition and rebuilding) and re-housing of lower-income inner-city populations (Power, 1993). This had a direct effect on the amount of privately rented accommodation available as most of the slums were in that sector. The new housing was typically built in the form of large estates and at high densities, sometimes in the form of high-rise apartment blocks – where the slums had been cleared – but also in estates at the margins of urban areas. In addition, the role of local authorities in housing was extended in the 1970s by the Homeless Persons Act 1977 which gave them a more general responsibility to ensure adequate housing in their borough (Boelhouwer and van der Heijden, 1992).

The housing policy pursued by the Conservative government between 1951 and 1964 placed more emphasis on promoting the private sector, particularly owner-occupation. In particular, taxation of the imputed rental income of home owners, which had been in place since the eighteenth century, was removed in 1963. This increased the tax benefits of owner-occupation as compared to private renting. However, the government maintained local authorities' capacity to build with the help of local subsidies and rent surpluses, and continued to support slum clearance programmes.

In the private rented sector rents had been maintained at 1939 levels, but through the 1954 Housing Repairs and Rents Act the Conservative Government allowed some limited increases for dwellings in good repair. It also freed new and converted private rental units from rent controls. These changes had little or no effect on investor behaviour as the system was so far out of equilibrium. Thus the Act did not lead to significant new construction of private rental housing or indeed to any large scale programme of repair (Harloe, 1985).

The 1957 Rent Act was a much more comprehensive measure intended to tackle five problems in the PRS: under-occupation, lack of labour mobility, the unwillingness of landlords to make repairs, anomalies arising from properties of similar market value having different rents and the lack of adequate returns on new investment in the sector (Headey, 1978; Heath, 2013). The 1957 Act immediately decontrolled rents on more expensive properties as well as across the market when there was a change of tenancy. This meant that 4.25 million properties out of the seven million in the PRS were still subject to rent control but it also enabled creeping decontrol when tenants left. The Act showed how many landlords had been held in the sector by regulation – and the effect of relaxation was to reduce investors' involvement in the PRS rather than to expand investment. Large numbers of properties were transferred into owner-occupation through sales, either to sitting tenants or when they fell vacant, in part because of the fear that rent control would be re-imposed. Tenants' increasing access to building society mortgages as incomes rose helped to support this transfer.

The private rented sector as a political football continued once Labour was re-elected. The 1965 Rent Act introduced a different form of rent control in the form of 'regulated tenancies' with 'fair rents' for unfurnished private rental properties, the levels of rents to be determined by local Rent Officers. Rents in the furnished sector remained market determined until 1972 when the furnished PRS was brought into the system (resident landlords were however exempted from regulation). After a number of scandals, the 1977 Protection from Eviction Act further constrained landlord powers to evict their tenants. In addition the 1974 Labour government introduced a municipalisation programme by which local authorities could purchase dwellings on the market, including large numbers of privately rented properties, often in disrepair.

Policies during this period helped to generate continued decline in the private rented sector. Indeed, the proportion of private rented dwellings in England's total dwelling stock was reduced from 32 percent of 11.7 million dwellings in 1951 to 12 percent of 17.8 million dwellings in 1979 – an absolute reduction of some 1.75 million units.

Other factors which reinforced decline included relatively rapid economic growth over much of the period; rapid general and house price inflation in the 1970s which favoured owner-occupation because sales were not subject to capital gains tax as compared to private rented housing; and, starting in the late 1960s, some liberalisation of housing credit. As a result the role of the PRS in the English housing system was seen as 'residual' – housing the young and

mobile, providing accommodation with employment and acting as tenure of last resort for those unable to find accommodation in the majority tenures (Bovaird, et al., 1985).

#### 4.1 Major drivers affecting PRS size and investment, 1945 - 1979

Local authority sector	Private rented sector	Owner-occupation	Economic environment	Outcomes for PRS
Large scale investment in new building and improvement	Slum clearance	Support for new build	Economic growth in 1950s and 1960s	Decline in sector in proportional and absolute terms
Municipalisation in 1970s	Rents deregulated, then modified re-regulation	Sales from PRS	Rapid inflation in 1970s	Almost no new investment in PRS
Income-related rent rebates from 1972	Incentives to improve and new construction in 1950s	Improved tax reliefs		
	Standards regulation	Improved access to mortgage finance especially in 1970s		
	Income-related housing allowances from 1974			

#### 4.2 1980 - MID-1990S: EXPANDING OWNER-OCCUPATION AT THE EXPENSE OF THE RENTED SECTORS

The Conservative government elected in 1979 adopted a housing policy based on privatisation and liberalisation, cutbacks in public expenditure and restructuring housing subsidies.

The Conservative government regarded owner-occupation as an essential component of a ‘property owning democracy’ and promoted owner-occupation to all households except the most disadvantaged (Saunders, 1990). The most immediate policy to promote owner-occupation was the Right to Buy. Introduced under the Housing Act 1980, it required local authorities to offer tenants the opportunity to buy their council-owned houses at substantial discounts from the market value. Between 1980 and 1997 1.3 million council homes in England were sold, with a further 600,000 between 1997 and 2014 (DCLG, Live table 671). The focus of the social rented sector was shifted away from housing mainstream tenants to provision for the most disadvantaged, such as homeless households, the elderly and the disabled (Lee and Murie, 1999). Overall, the success of the Right to Buy had a profound effect in changing the tenure structure in England (Forrest and Murie, 1988). In particular it contributed to a significant growth in the owner-occupied sector during the worst of the economic recession in the period 1981–1987 (Malpass, 1993, p.78). However by 2014 it is suggested that more than one in three of these dwellings – nearly 700,000 units – is now in the private rented sector (Copley, 2014; Apps, 2014).

The 1980 Housing Act also introduced new forms of assured and shorthold tenancies in an attempt to help rejuvenate the PRS but these had little immediate impact.

Another important initiative which benefitted owner-occupation was finance market liberalisation which made it worthwhile for mainstream banks to enter the mortgage market and resulted in much easier and cheaper access to mortgage finance for larger numbers of households (Scanlon and Adamczuk, 2016). The only major offsetting policy was a series of restrictions on mortgage tax relief which significantly reduced the value of this benefit from 1990 and phased it out completely in 2000.

Of more immediate importance was that from 1989/90 there was a major economic crisis with rapidly increasing unemployment, large falls in real house prices and a sudden decline in inflation. The result was that many mortgagors fell into negative equity and there were large numbers of possessions, with the market not improving until the mid-1990s. It was during this period that owner-occupation started to fall among younger households, especially those in their twenties.

The 1988 Housing Act introduced a range of major changes to the social and private rented sectors. In the social housing sector, it introduced a mixed funding regime. Housing associations were to be provided with government grants and at the same time could borrow on the private finance market. The Act gave associations the freedom to set rents based on costs up to market levels (Malpass, 2000; Whitehead, 1999; Tang, 2008), which supported this commercial borrowing. The 1989 Local Government and Housing Act eliminated central-government subsidies to local authority housing and limited authorities' capacity to borrow for housing purposes (Malpass and Warburton, 1993). It also provided the legal framework (and incentives) for large scale voluntary transfer (LSVT) of local authority properties to housing associations, further reducing numbers of council-social rented accommodation (Malpass and Mullins, 2002; Pawson, et al., 2009). The Right to Buy, LSVTs and falling public expenditure together led to rapid declines in the local authority sector housing which were only partially offset by housing association investment.

The 1988 Act also completely deregulated the PRS. It abolished rent regulation for new leases signed from 1 January 1989. Landlords were permitted to charge full market rent and to increase rents as set out in tenancy agreements rather than by an amount specified by statute. However, tenants could apply to the Rent Assessment Committee if they felt increases were too high. Existing tenancies begun before 15 January 1989 were still 'regulated tenancies' (subject to 'fair rents'). The 1988 Act also introduced the Assured Shorthold Tenancy (a minimum six-month tenancy with no further security of tenure) which subsequently became the default type of tenancy under the 1996 Housing Act, and required landlords to give tenants a minimum of two months' notice.

The government introduced one important short-term tax advantage to the PRS in 1988. It extended the Business Expansion Scheme, which gave incentives to small investors to get involved in more risky business start-ups, including to landlords of newly constructed assured tenancies for the period 1988 - 1993. During that period some 81,000 dwellings were added to the PRS stock, although a high proportion of the units provided were only available to students (Crook et al 1995; Hughes, 1995).

The very limited security of tenure introduced by the Assured Shorthold Tenancy together with increasing competition among mortgage lenders created the conditions for the mortgage industry to lend more easily to private landlords. Following a 1994 initiative by the Association of Residential Letting Agents, the Buy-to-let mortgage from July 1996 became available to private landlords to purchase property to let. The loans were usually interest only, based on projected rental income, with loan-to-value ratios of up to 85 per cent of



capital values and at interest rates little above those for owner-occupiers (Rhodes, 2006; Ball, 2006).

A further initiative, housing investment trusts (HITs) were introduced in 1996 in order to bring pension and other long term funds into privately rented housing, including existing lettings. However major investors did not see them as worthwhile and no HITs had been set up by 2010. The introduction in 2005 of UK-REIT (real estate investment trusts) legislation, based on the US model, made it possible for liquid and publicly available property investment vehicles to be available to a wide range of investors, with the aim of encouraging increased institutional and professional investment in both commercial real estate and privately rented investment (Ball and Glascock, 2004). UK-REITs have been allowed to operate since January 2007. Most invest in commercial and retail property, although a small number also invest in rental accommodation. As yet, there are no REITs that are solely for residential property

In 1980 the PRS consisted of some 2.1 million units, somewhat less than 12 per cent of the total stock. In 1996 the number of units was almost exactly the same, but accounted for only just over 10 per cent of the stock. However in the interim there had been further decline, to as low as 1.8m in the mid-1980s, and this loss was only slowly offset from the early 1990s. Even then, Crook and Kemp (1996) pointed out that half of the expansion during the early 1990s could be explained by 'property slump landlords' who were unable or unwilling to sell at that time because of the state of the owner-occupied housing market.

**Table 4.2 Major drivers affecting PRS size and investment 1980 - 1996**

<b>Local authority /social sector</b>	<b>Private rented sector</b>	<b>Owner-occupation</b>	<b>Economic environment</b>	<b>Outcomes for the PRS</b>
<p>Right to Buy</p> <p>Reduced subsidy to local authority housing leading to higher rent</p> <p>Local authorities' ability to borrow and provide local subsidies for housing purposes removed</p> <p>Capital grants to housing associations</p> <p>Mixed funding regime for housing associations</p>	<p>Introduction of assured and shorthold tenancies 1980</p> <p>Assured Shorthold Tenancies with minimum six months security introduced 1988</p> <p>Business Expansion Scheme (BES) tax reliefs 1988 - 1993</p> <p>Buy to let mortgages introduced 1996</p>	<p>Right to Buy significantly increased the size of the owner-occupied sector</p> <p>Liberalisation of mortgage credit</p> <p>Reductions in mortgage tax relief</p> <p>Improved access to mortgage finance especially in 1970s</p>	<p>Major economic and housing crisis 1989/90</p> <p>Large numbers of possessions and mortgagors in negative equity</p> <p>Low inflation environment from early 1990s</p>	<p>The decline in the sector showed signs of being reversed - even though the PRS was roughly the same size at the end of the period as at the beginning.</p> <p>The BES scheme showed investment in the PRS was possible with significant tax breaks</p>

### **4.3 1997–2010: WORSENING AFFORDABILITY AND STRONG GROWTH IN THE PRS**

The Labour governments of 1997–2010 continued the Conservative’s market-driven housing policy, supporting owner-occupation; increasing the use of private finance for social housing; moving further away from rent-based subsidies to means-tested, individual rent allowances; and promoting ‘choice’ as a guiding principle of public service delivery (Le Grand, 2007).

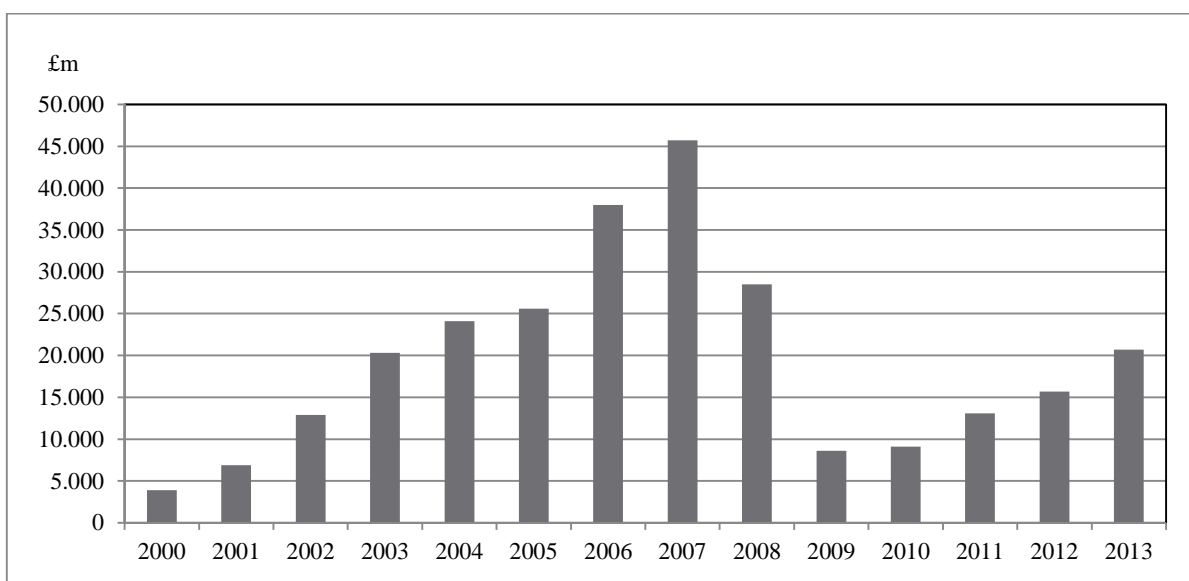
In social housing, the 2000 Housing Green Paper, *Quality and Choice: A Decent Home for All*, set the framework for rent restructuring to make rents consistent across the social rented sector in the 10-year period from 2002 to 2012 (DETR and DSS, 2000). Rents on existing properties were allowed to rise by RPI plus one per cent and new tenancies were set in line with national rules.

In the owner-occupied sector mortgage tax relief was finally phased out in 2000 but the big changes were in the finance market where self-certified, interest-only and longer term mortgages were introduced. However house prices rose rapidly especially after the turn of the century and the numbers of first-time buyers fell from 2003. From 2008 credit availability was extremely limited and required deposits rose from an average of 10 per cent to 25 per cent. As a result the number of first-time buyers fell even further, to as low as 200,000 in 2010 compared to 590,000 in 1999. For those excluded from owner-occupation the only options were continuing to live with parents or becoming private tenants. Equally, many existing owner-occupiers could not easily sell their homes so entered the rental market.

In the PRS, the main focus of policies was to stimulate the supply of private rental dwellings by institutions rather than individual investors, even though the latter dominated – and continue to dominate – the PRS. Initiatives included the BES scheme noted above; the Housing Investment Trust Scheme (HITs) (Crook et al, 1998; Crook and Kemp, 2002) and the introduction of Real Estate Investment Trusts (REITs).

The government introduced regulations to improve standards of the PRS in the 2004 Housing Act including mandatory licensing of private rental houses in multiple occupation (generally those let to three or more unrelated people); a new housing fitness standard for the PRS; local council powers to take control of a property that was not being managed responsibly and safely for the benefit of the occupiers; and an approved tenancy deposit scheme. However the most important factor leading to improvements in the PRS came from the increased flow of investment into newly constructed dwellings from small-scale buy-to-let landlords.

**Figure 4.1. Buy-to-let gross mortgage advances, 2000–2013**



Source: CML Table MM17 Buy-to-let gross advances.

Indeed the growth of the PRS depended almost entirely on small investor activity, largely financed through buy-to-let (BTL) mortgages. From their introduction in July 1996, BTL mortgage advances increased to over 346,000 in 2007, with a value of over £45.7 billion (Fig. 4.1).

A report by Rugg and Rhodes (2008) identified the most important factors generating the demand for private renting. They were:

- enhanced student numbers;
- increased inward migration;
- higher levels of relationship breakdown;
- increased demand that would otherwise have been catered for in the social rented sector;
- growth in the numbers of younger tenants renting for ‘lifestyle’ reasons; and
- worsening affordability problems for those wanting to access home ownership.

This increasing demand was met in part from newly constructed dwellings, but mostly from the transfer into private rental of existing units that had been in the social and owner-occupied sectors. Although some 220,000 dwellings were built for the social sector over the period 1997- 2010, the number of units fell by nearly 500,000. Equally 1.6 million private units were built but owner-occupation rose only by around a million. In part this was because of the growing numbers of Right to Buy dwellings which moved into private renting; in part because after the global financial crisis owner-occupiers who could not sell became landlords instead.

Overall in the period 1997-2010 the private rented housing stock increased by some 85 per cent, and as a proportion of the stock grew from just over 10 per cent to around 17 per cent. By 2010 there were some 3.9 million privately rented units – a figure last seen in the mid-1960s. Far more of these additions were newly built homes than had been the case since the 1930s. Although exact numbers are not known, a government analysis (HM Treasury, 2010) based on a sample of BTL mortgages between 2004 and 2007 suggested that BTL might have contributed to 35,000 units a year, or around a fifth of all new completions.

**Table 4.3 Major drivers affecting PRS size and investment 1997 - 2010**

<b>Local authority /social sector</b>	<b>Private rented sector</b>	<b>Owner-occupation</b>	<b>Economic environment</b>	<b>Outcomes for the PRS</b>
<p>Right to Buy continued</p> <p>Reduced subsidy to local authority housing leading to higher rents</p>	<p>Growing importance of buy to let mortgages</p> <p>Some incentives to institutional investors</p>	<p>Easier access to mortgage funding until 2008 when became extremely difficult</p> <p>Removal of mortgage tax relief</p>	<p>Low inflation continued but house prices rose rapidly from early 1990s</p> <p>Incomes growth did not keep pace with house prices</p> <p>Reduction in interest rates from 2008</p>	<p>Private rented sector grew rapidly mainly from existing units</p> <p>A proportion of buy to let properties newly built</p> <p>No evidence of institutional investment</p>

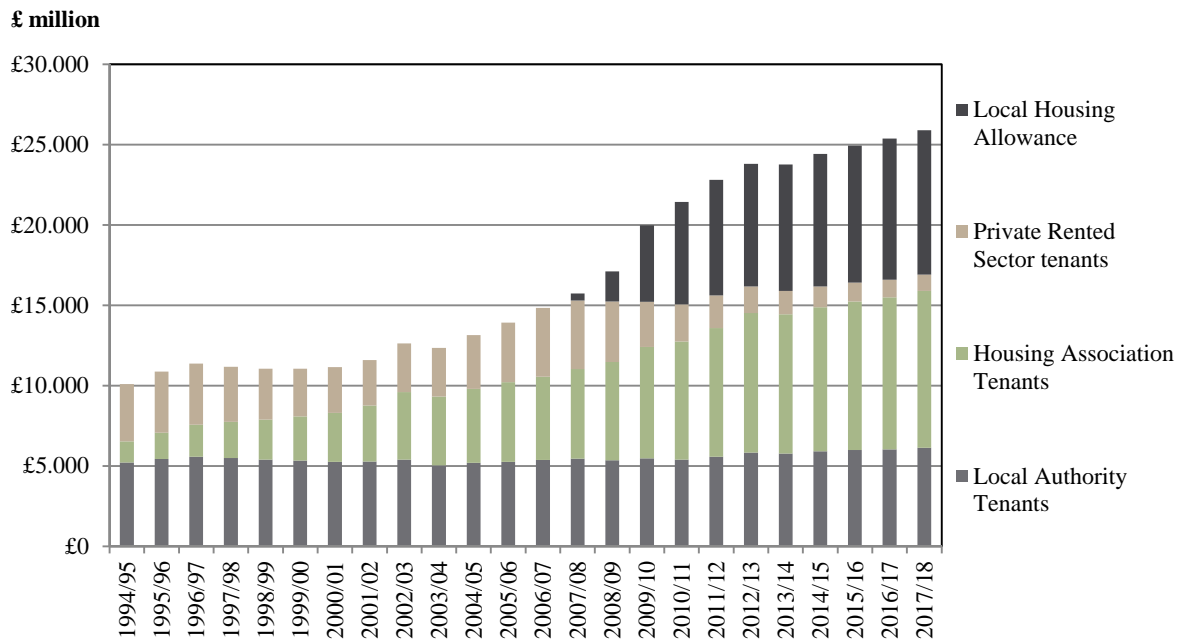
#### **4.4 2010 ONWARDS – CONTINUING EXPANSION IN THE PRS**

The Conservative-Liberal Democrat Coalition Government elected in May 2010 put the highest priority on reducing the financial deficit by imposing sweeping reductions in public spending (Taylor-Gooby, 2012). This was also a key strand of the Conservative manifesto in 2015.

The 2010 Comprehensive Spending Review announced an almost three quarters cut in capital expenditure on social housing (Jacobs and Manzi, 2013). New building was to be maintained through a new ‘affordable housing’ model, under which social landlords could charge rents on new property of up to 80 per cent of market rates. Vacant units could also be transferred to affordable rent. Housing Associations were required to reinvest the additional income in new housing. This allowed greater borrowing and generated around 180,000 new units up to 2015. The funding model for local authority housing was also modified to enable additional provision. Even so the size of the social housing sector continued to fall, in part because of the revival of Right to Buy.

A second element in the austerity package was an attempt to control the Housing Benefit bill. Over the period from 2010 to 2015 a large number of detailed changes were made to the Local Housing Allowance (LHA, the PRS form of housing benefit which applied to below median rents in the locality) with the aim of restricting eligibility and reducing rents in the PRS. The evidence suggests there was little impact on rents, and that tenants have borne the brunt of these changes (Brewer et al, 2014). As Figure 4.2 shows, benefits to private tenants (which include both PRS and LHA) have continued to increase.

**Figure 4.2 Housing benefit expenditure by tenure, Great Britain, 1994/95–2017/18 (£ million)**



Source: Outturn and Forecast, Autumn Statement 2013, Housing Benefit  
<https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2013>

Overall, LHA has acted as an important ingredient to support the demand for privately rented accommodation. Increasingly, and especially since 2010, private rented dwellings have become a major source of accommodation for homeless households and more generally a substitute for council and housing association housing for lower-income households (Kemp, 2011). Universal Credit will increasingly take the place of the LHA, starting from late 2013 but not becoming important until 2016/17. It integrates housing benefits into a broader based income support system which will continue to maintain the PRS’s role in compensating for the lack of social housing for the poorest households.

The policy goal of attracting institutional investment into private rental housing once again came to the fore after the 2010 change of government. The March 2011 Budget contained a set of measures aimed at creating a more tax-efficient approach to large scale investment through REITs (Stephens and Williams, 2012). However of themselves these changes did not stimulate an incremental flow of institutional investment into new housing built specifically for rent. After an independent review of ways to attract institutional investment into the sector (Montague, 2012), the policy priority shifted to the development of a new ‘Build to Rent’ scheme. This term describes large-scale purpose-built rental-only blocks that are in single ownership, an industry model common in many European countries but not seen in the UK since the 1930s (Pawson and Wilcox, 2013; Scanlon, et al., 2013). The first group of Build to Rent projects, announced on 16 April 2013, will contain up to 10,000 new homes. In addition the UK Government announced a £10 billion debt-guarantee scheme to support new build to rent developments in the UK (Wilson, 2014). Overall, these two measures aimed to reduce the costs and risk of finance at different stages of development and ownership of the new private rental dwellings.

Despite all these government efforts, the role of institutional investors in the PRS is still negligible. Most of the institutional investments in large-scale rented housing are in London. A recent survey of institutional investors by the Investment Property Forum suggested that of a total £180 billion in property assets held by 42 institutions, only four per cent was invested in residential, and of that under half in PRS assets. This was an extremely small amount, compared to the total estimated £2.7 trillion size of UK institutional assets under management (CBI, 2013).

A number of studies have looked at why institutional investors have not become significant players in the residential property market and have generally identified a common set of factors (Daly, 2008; HM Treasury, 2010; Hull, *et al.*, 2011; Scanlon, *et al.*, 2013):

- the difficulty that developers of PRS-specific buildings have competing for land against owner-occupation;
- lack of development finance;
- low risk-adjusted yields;
- lack of investor experience in the sector together with the very limited performance data on which to base decisions;
- the need for scale: Savills (2014) comments that the lack of large-scale purpose-built private rental stock and the operational platforms to run them is the main barrier to investors in PRS (see also Milligan, *et al.*, 2013).
- negative investor and local government attitudes to the sector: it has been suggested that some local authorities have not adopted the pro-growth approach of the National Planning Policy Framework and have blocked the supply of new housing in their areas (CBI, 2013).
- poor quality and expensive management;
- reputational risk; and
- uncertainties around the regulatory and taxation regimes.

Finally, in the owner-occupied sector the number of first time buyers started to pick up from 2012 assisted by the Help to Buy programme from 2013. Under this scheme the government provides an interest free 20 per cent equity loan on new homes for five years which allows lower deposits and monthly repayments. By 2014 there were more than 300,000 first time buyers and this level has been maintained in 2015. However this is still well below the average before the financial crisis. This is partly due to restrictions on mortgage lending introduced in the wake of the mortgage market review (Montague, 2012), which took effect in 2014, but also to continued concerns about the economy and the fact that although employment has risen there has been little impact on individual incomes.

Neither policy changes nor market changes have done much to slow the growth of the private rented sector. Between 2010 and 2014 the private rented stock grew by around 675,000 units while owner-occupation fell by around 185,000 and social housing grew by some 45,000 units. As a result the private rented sector now accounts for almost 20% of all dwellings.

Pawson and Wilcox (2013) argue that, although some rented properties are newly built, mainly entering the sector as Buy to Let purchases with, as yet, very limited institutional investment, the recent expansion of the PRS is largely fuelled by transfers of existing homes from other sectors. New building is still mainly aimed at social housing and the owner-occupied market. If the housing market recovers, these dwellings may transfer back to owner occupation (Scottish Government, 2013).

Most recently the Conservative government has shifted policy towards expanding owner-occupation through the Starter Homes initiative, under which developers are required to provide homes for low-cost purchase rather than social or affordable rent, and the continuation of Help to Buy. Dwellings are also to be transferred from the social sector into owner-occupation through extending the Right to Buy to Housing Association tenants – and the money this generates will pay for new housing, some of which will be for owner-occupation. Small individual buy-to-let investors on the other hand are to lose some of their tax reliefs, in part for macro-stabilisation reasons Scanlon et al, 2016). They will also be required to pay higher transaction taxes on purchases of investment properties to prevent ‘unfair’ competition with first-time buyers.

As at 2015 the relative tax position between owner-occupation and private renting can be categorised as:

- owner-occupied housing is treated as a consumption good in that there is no tax on imputed income but equally no allowances for mortgage and other costs. Most importantly in the English context the principle home is exempt for capital gains tax. The government is also intending to exempt properties valued at under £1m from inheritance tax if the property is left to the children;
- subsidies to support entry into newly built homes include the Help to Buy 20 per cent interest free equity loan for five years and starter homes available to first time buyers with a 20 per cent discount on market value;
- tenants pay rents out of taxed income; low income tenants receive Local Housing Allowance based on income, rent and household composition;
- landlords pay tax on PRS income as an investment in a perpetual asset – ie there is no depreciation allowance and tax is paid net of costs. These costs, including mortgage tax relief at basic rate tax or company tax rates and other costs of renting out property are deductible– with some constraints. Sales are subject to capital gains tax
- Developers building for the PRS may benefit from the Build to Rent Fund and institutional investors from low cost debt finance guaranteed by government.

**Table 4.4 Major drivers affecting PRS size and investment 2010 -2015**

Local authority /social sector	Private rented sector	Owner-occupation	Economic environment	Outcomes for the PRS
Right to Buy continued and extended to housing associations from 2016	Policies to support developers and institutional investors in new PRS dwellings	Help to Buy initiative to support households into new dwellings from 2013	Low inflation Low interest rates	Private rented sector grew rapidly mainly from existing units
Reduced subsidy to local authority housing leading to higher rents	Support for lower income tenants through local housing allowance faced increasing restrictions  Tax reliefs reduced for Buy to Let mortgagors  Transaction taxes increased for small landlords	Starter Homes initiative  Mortgage Market Review further limiting access to credit	Slow economic growth  Increased employment but limited income growth	A proportion of Buy to Let properties newly built.  Some evidence of limited institutional investment.

#### 4.5 CONCLUSIONS: KEY CHANGES IN INCENTIVES AND CONSTRAINTS IN ENGLAND

One aim of this analysis is to identify those moments when incentives and constraints changed, and consumers and providers modified their behaviour enough to affect the scale and role of the PRS. We are looking particularly for changes in incentives to undertake new investment.

The analysis points clearly to the importance of political change. The four stages we identified are all associated with particular governments and their different ideologies. Governments pursued their policy goals by

- changes in regulation – not just of the PRS but also of the finance market, which modified households' capacity to choose tenure, and of social sector powers and responsibilities with respect to homelessness, the right to build and the Right to Buy;
- changes in subsidies to the social sector, to owner-occupiers and to tenants; and
- tax changes, notably with respect to owner-occupation and the PRS.

Not all of these were instrumental changes aimed at particular behavioural or economic outcomes – many were driven by ideology. And while in retrospect we can identify the key importance to the evolution of the PRS of certain policies (e.g. the 1988 Housing Act), we cannot assume that policy-makers at the time intended or foresaw those longer-term effects.

What is also clear is that the economic environment changes the importance of particular policy interventions and so generates outcomes which vary with that economic environment. In this context the three most important factors are:

- income growth, which opens up housing and investment choices to government and consumers alike;
- inflation, which interacts with the tax system massively to change the incentives for households to be in a particular tenure;
- macro-economic volatility, which changes both interest rates and the risks around tenure choices and interacts with macro-stabilisation policies to expand or limit choices notably in response to the global financial crisis.

In the English context, the most important events that could be expected to have changed incentives and behaviour were:

- 1957 when major rent decontrol was introduced (user-cost increases for PRS tenants; returns on landlord investment increased – but not to competitive levels);
- 1974 when income related benefits for private tenants were introduced (net user cost for PRS tenants falls);
- 1977 when the Homeless Persons Act was passed giving local authorities responsibility for re-housing those accepted as homeless in later periods (increases demand for PRS);
- 1980 when there were regulatory changes both to the PRS and to the finance market for owner-occupation plus the Right to Buy for council tenants came into force (reducing demand for PRS – but in later periods increasing supply);
- 1989 when full decontrol of rents and short term security of tenure were introduced and at the same time the economy and the housing market faced a major downturn (user cost increases for *new* PRS tenancies though more apparent in the long term



than in Year 1; rental returns on landlord investment increase, again more apparent in long term, but offset by negative expected capital gains)

- 1996 when buy-to-let mortgages, an industry initiative to expand the market, first became available (helping overcome constraints on landlord borrowing and so increased both the number of landlords able to invest and the amount they could borrow);
- 2007/8 the global financial crisis resulted in massive shortages in credit availability, reduced transactions in the owner-occupied sector and pushed both supply and demand into the PRS; and
- 2015, when changes in subsidies and tax reliefs were introduced (reducing returns to small individual landlords in particular and increasing incentives to enter owner-occupation).

What is very obvious from this list is that most of the policy changes can be expected to be slow burners and that they interact with one another and sometimes pull in different directions. As a result there can be no simple picture. What is also clear is that there was undoubtedly a turning point somewhere in the 1990s – probably starting from 1990 itself – when demand moved more towards private renting and that this shift has accelerated since 2000 and again since the global crisis.

What is less clear is how much this change in demand has impacted on new investment. It is clear that private landlords have remained in a relatively poor tax position both as compared to owner-occupiers, at least with respect to capital gains, and as compared to investments that allow depreciation. The 2015 changes worsen that position. So whether or not it is worth investing depends significantly on the relative importance of rental income and capital gains. As compared to business investment the decision depends on risk and return – which is why the government is looking to bring in institutional investors interested in longer term predictable rental returns. This has clearly not yet been successful – arguably in part because of the uncertainties surrounding the sector and the price of housing which is mainly determined by owner-occupier demand.

# Chapter 5: Drivers of change in the size and role of the private rented sector in Germany

## 5.1 SEVEN DECADES OF HOUSING POLICY

The market economy in the former West Germany and the planned economy in the former East Germany, each characterised by a distinct social, political and economic background, were merged during reunification in 1990. Today, the German housing system is characterised by the following features. First, it has a large private rental sector<sup>1</sup>, and the owner-occupied housing sector is smaller than in many European countries. Second, social housing programmes provide direct subsidies to rented housing as well as to owner-occupation. Unlike many European countries, public authorities make only a marginal contribution to the social rented housing stock. Approximately one-third is provided by private landlords and two-thirds belongs to housing associations (*Gemeinnützige Wohnungsunternehmen*, which became private landlords when their tax privileges expired in 1989). Third, taxation favours investment in housing generally, and there are only modest differences between the different tenures.

This chapter identifies and traces the significance of some general political and economic changes that affected the supply and demand of private renting in Germany over the last 60 years. The review charts the development of the German housing system in five timeframes: 1950s–1960s, 1970s, 1980s, 1990s, 2000s, mid-2010s. We then turn to the current tax and subsidy system as it affects private rented housing and the comparative position of other tenures.

### ***Post-war period: large subsidies for housing construction and gradual relaxation of rent control (West Germany)***

Directly after 1945, West Germany engaged in a massive new construction programme to compensate for the loss of some 5.5 million dwellings during the war years (Power, 1993). First, rent control in the form of a nominal rent freeze was imposed. Then, the federal government set out the First Housing Act of 1950 (*I. Wohnungsbaugesetz*) which marked the beginning of ‘social’ or subsidised assisted housing in Germany. The construction of social housing was promoted by direct subsidies and public guarantees, declining-balance depreciation (so that the depreciation charge declines over the life of the building) and exemptions from real property tax. The Act was amended in certain aspects in August 1953, and further amendments were incorporated in 1955. It distinguished three types of housing (Wendt, 1962):

*i. Social housing in receipt of direct subsidies and low-interest-rate loans from public funds*

Subsidies for new social housing development were available not only to municipalities and other public housing authorities, public (non-profit) and private (for-profit) housing associations (see Seemann, et al., 2014), but also to private builders. Those receiving such subsidies were required to charge social rents for a fixed period which – depending on the scheme – lasted for up to 30

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<sup>1</sup> This includes the rental sector in former East Germany, which was classified as private rental after reunification although it had many features of social rented housing.

years. Subsidised social housing was intended primarily for the broad masses of individuals in the lower income groups. There were restrictions on dwelling size, rents and tenant incomes. When the subsidy lock-in period expires these dwellings become subject to the regulatory regime of the private rented sector.

During the early days of social housing, a standard rent was fixed by the authorities. This rent was based on landlords' costs, calculated according to defined principles, and in most cases was appreciably below the market rent (Voigtländer, 2009).

ii. *Other housing aided by tax concessions and tax exemptions*

Certain newly constructed dwellings were exempt from the annual land tax for 10 years and any costs, including depreciation, could be set against income from any source (Tomann, 1990). There was a dwelling-size limit, although housing projects utilising tax concessions and exemptions generally provided homes larger than those in the subsidised social housing projects.

iii. *Private housing funded entirely by private money without any financial privileges.*

The First Housing Construction Act of 1950 set a goal of producing 1.8 million new social dwellings over a six-year period. This goal was reached by 1956, and by 1959, social housing accounted for 55 per cent of total dwellings completed (Wendt, 1962, Table V-6).

Recognising that the rent freeze at pre-war levels was holding rents at an uneconomic level, a rent law was enacted in 1954 which allowed an increase of 10 per cent in rents for all dwellings constructed prior to the currency reform in 1948, and an increase of 15–20 per cent for dwellings with central heating and other amenities. It also allowed landlords to charge supplementary rents if repairs were made. Supplementary charges for repair in older buildings were not included in the standard rent on which the permanent increases were to be calculated. The purpose was to prevent the dilapidation of older buildings. As a result of these changes, the index of residential rents for all income groups rose rapidly to 120 per cent of the 1945–50 level by 1958 (Wendt, 1962).

The Second Housing Law of 1956 (*II. Wohnungsbaugesetz*) promoted owner-occupied housing construction according to similar principles as those for social housing, but the number of new dwelling units initially for the rental market nevertheless always exceeded the number of new owner-occupied properties in the 1950s. This is probably due to the fact that the market for private mortgage financing had not been established, which meant that households wanting to buy a home had to find a deposit of between 35 and 40 per cent of the equity (Voigtländer, 2009).

A new rent regulation, effective from August 1958, simplified former rent restrictions on approximately nine million existing dwellings (Wendt, 1962). Rents were deregulated incrementally from 1961 onwards under the 'Act on the Cutback of Housing Control and on Socially-oriented Rent and Housing Legislation' (*Gesetz über den Abbau der Wohnungszwangswirtschaft und über ein soziales Miet- und Wohnrecht*; Lerbs, 2014) in so-called 'white districts' (regions in which the housing shortage was below three per cent). At first, only 52 districts were liberalised, but by 1968, only Berlin, Hamburg and Munich still applied rationing systems and rent control. Because of the decontrol and subsequent soaring of rents, housing allowances (*Wohngeld*) were introduced in 1965 (Tomann, 1990). Additionally in 1960, the West German government established the comprehensive tenant

protection laws in the Code of Civil Law which included rules governing protection against eviction by landlords.

***1970s: introduction of comparable rents and limits on rent increases (West Germany)***

The inflationary period of the 1970s led to a boom in housing construction and excess supply in the housing market until the end of the decade. Also, the rent control system applied throughout the 1950s and 1960s led to a widespread problem of derelict housing in inner cities. To tackle urban decay in cities and to combat land speculation, the Social-Liberal coalition government created a new urban development policy in 1971 which included large-scale social housing construction programmes.

The federal government also enacted the 1971 Protection of Tenants from Arbitrary Eviction Act (*Wohnraumkündigungsgesetz*). This prohibited eviction except under the following three conditions (Börsch-Supan, 1994):

1. if the tenant severely breaches the contract (eg does not pay the rent);
2. if the landlord or a close relative wants to move into the unit and has a just cause for doing so; or
3. if the landlord is severely inhibited in the appropriate economic usage of his/her property (eg conversion into office space in areas assigned by zoning laws as a business district).

The courts have been very restrictive on the two latter clauses and rarely permit such evictions.

The 1971 Act also abolished rent control and introduced a local comparable market rents system (*Vergleichsmietenregelung*). The comparable rent is typically differentiated by type, size, condition and quality (including features related to energy use), as well as the location of the building. Under this system, which is still in place today, rents can only be increased if they have not been raised during the last year, and if the landlord proves by referral to a rental index (*Miethöhegesetz*) or by reference to existing, comparable tenancies (*Mietspiegel* translated as rent mirror; Oxley et al, 2010). Since the rental index is always calculated on the basis of past rents, the rent level is always below the level in the actual market when rents on the whole are increasing. Therefore, especially for long-staying tenants, renting a new apartment or buying a home can be unattractive since their current housing costs are below market prices (Hubert, 1998). Complementing the new system, rent adjustments for sitting tenants are regulated by putting an upper limit, and the rent cannot be raised within three years by more than 20 per cent. Apart from 'normal' rent increases, landlords are allowed to increase rents after modernisation, including energy modernisation, with a maximum of 11 per cent of modernisation costs (Cornelius and Rzeznik, 2014). However, there is no restriction on the rent level for a new letting.

In 1976, important tax concessions were extended to owner-occupiers buying dwellings from the existing stock. This promoted substantial conversions from rented dwellings to owned condominiums, often at the same time as major improvements (Tomann, 1990).

This period also saw the start of a shift in the target group for housing policy. From subsidising broad sections of the population, housing policy began to target lower-income groups and particularly families (Haffner et al, 2009).

At the end of the 1970s, high inflation and interest rates greatly increased the cost of social housing construction, which fed through to increased public expenditure. The Social-Liberal

government and the *Länder* governments attempted to reduce expenditure by shifting from capital grants to annuity payments. Also, subsidised rents were increased in line with inflation so as to keep costs under control (Tomann, 1990).

### ***1980s: shift from supply subsidies to housing allowances (West Germany)***

In the 1980s, the federal government executed a monetary stabilisation policy to counteract the moderate economic growth and rising unemployment, together with the deceleration of inflation. However, the stabilisation policy led to a sharp rise in the long-term interest rate. In this economic environment, the new Christian-Liberal coalition government (since 1983) promoted a fundamental deregulation of the housing market. The government began to shift the emphasis of housing policy from supply subsidies to housing allowances. Also, after the collapse of *Neue Heimat* (the largest housing association in Western Europe), tax exemptions for non-profit associations were abolished in the context of a general tax reform. Mainly to stimulate construction activity and economic growth, temporary tax deductibility of mortgage interest for owner-occupiers was introduced between 1983 and 1987, and this successfully halted the decline of housing construction activity. But the measure proved costly and was cancelled as part of the tax reform (Tomann, 1990).

The 1980s saw the introduction of more market forces and decentralisation. Central government began to step back from providing direct bricks-and-mortar subsidies. The mortgage interest deduction and the imputed rent taxation were abolished in favour of a depreciation deduction (Haffner et al, 2009). Since 1988, federal and *Länder* governments have steadily reduced their influence on the supply side of the housing market, turning instead to housing allowances and subsidies for acquisition of existing dwellings (Droste and Knorr-Siedow, 2007).

In 1988-89, however, West Germany was faced with an influx of *Aussiedler*, people of German origin mainly from the former Eastern Bloc countries. As the regular bricks-and-mortar subsidy schemes could not cope, the government increased its financial input into social house building in 1989 (Tomann, 1990). The number of subsidised new-build dwellings increased from 65,000 to 111,000 in 1993 (Haffner, et al., 2009).

### ***1990s: review of the Rent Act and abolition of subsidies for new housing construction (Germany)***

German reunification in 1990 involved the transformation of the East German housing system towards a market-based economy, which included large-scale transfers of predominantly state-owned multi-family buildings to communal housing companies and housing co-operatives<sup>2</sup>. Such transfers set the stage for co-ordinated and publicly subsidised (dis-)investments in slab-built high-rise multifamily houses that were economically obsolete in many cases. The German approach of transforming the socialist housing system substantially differed from most other post-communist economies, which saw large amounts of public rental housing stocks directly privatised to their inhabitants. As a result, the ownership of former East German rental housing is comparatively concentrated, with 25 per cent of eastern German housing units located in a building owned by a communal housing company or a housing cooperative. In some metropolitan areas, this share reaches more than 50 per cent (Lerbs, 2014).

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<sup>2</sup> At the time of reunification, the homeownership rate in the former socialist part of Germany (East) was about 20 per cent while in West Germany it was over 40 per cent (Weinrich, 2014).

After reunification there was an unexpectedly high demand for housing, especially new single-family houses in suburban areas in the East. The immediate political reaction of the new all-Germany government was to continue subsidising social rental housing and to support construction by granting depreciation allowances of 50 per cent for new rental housing in East Germany between 1991 and 1998. Also, with effect from 1998, rent law and regulations were harmonised throughout the Federal Republic (Haffner, et al., 2009).

A new subsidy, *Eigenheimzulage*, was introduced in 1997 and ran until 2005 (Bischoff and Maennig, 2012). The goal was to increase homeownership by subsidising both the construction of new single-family private housing and the purchase of homes from the existing stock. Almost all households in Germany were eligible, in contrast to the targeting of social housing or housing allowance payments. The subsidy came in the form of a credit against federal taxes that could be taken annually for eight years. There was a basic allowance of 1% of the construction cost or purchase price of the building (up to €1,250 per year), plus €800 per child per year. The allowance began on the date of housing completion or stock purchase, and individuals could claim it only once. When the programme started the home ownership rate was approximately 39 per cent, and it had risen to 42 per cent by the end (Bischoff and Maennig, 2012). However the programme was estimated to cost €7.5 billion in 2004 (Ball, 2010), and because of the rising cost was withdrawn.

The result of the ending of this subsidy to home ownership was an increase in the supply of rented housing (Westerheide, 2011).

### ***2000s: reform of the Tenancy Act and the withdrawal of subsidy to social rented housing (Germany)***

At the end of the 1990s, roughly one million apartments were vacant, of which approximately 30 per cent were located in cities (Bischoff and Maennig, 2012). In 2002 and 2004, the program ‘Urban Restructuring in East and West Germany’ was implemented, and German housing policy underwent several changes. These changes included the creation of incentives for investment in the existing housing stock and funding for the demolition of uninhabitable stock.

The new bricks-and-mortar subsidy act of 2001 (*Wohnraumförderungsgesetz; WoFG*), which came into force on 1 January 2002, abolished the cost rent system for future construction, although it remains in force for those social dwellings covered by the pre-2002 regime. The 2001 law says the subsidy contract between municipality and landlord must stipulate a maximum rent; this can be negotiated on the basis of local rent level. Annual rent rises and other terms and conditions can also be negotiated between the two parties (Haffner et al, 2009).

In the private rental sector, there was a reform of the Rent Law, which came into effect on 1 September 2001. The aim of the 2001 Tenancy Reform Act (*Mietrechtsreformgesetz*) was to allocate rights and responsibilities more equally between tenants and landlords. Contractual freedom was enhanced to take account of individual situations. For instance, the notice period for tenants was reduced to a maximum of three months, while the notice period for landlords varied depending on how long the tenant had been in the dwelling, with a maximum of nine months. The new law also recognised various forms of cohabitation, enabling a non-married partner to take over an existing tenancy, for example (Haffner et al, 2009).

This reform also allowed municipalities to improve the collection of local rent statistics, which serve as a benchmark for permitted rent increases. So-called ‘qualified *Mietspiegel*’ calculations (a simplified means of mirroring the rents for similar properties in the locality) are produced by statisticians and approved by the municipality or the umbrella organisations of landlords and tenants. The calculations are updated every two years (eg by the rate of inflation), and new data collected every four. The advantage is that rent rises are easier to implement than with a normal *Mietspiegel*, especially where the rent is lower than the maximum local reference rent according to the *Mietspiegel* (Haffner et al, 2008).

With effect from 2004, the rate of depreciation for tax purposes for landlords was cut to 2 per cent. Furthermore, the subsidy element in the savings scheme, the *Bausparprämie*, was reduced in the owner-occupied sector. Lastly, at its third attempt, the central government achieved the abolition of the *Eigenheimzulage* subsidy for new applicants from 31 December 2005 (Haffner et al, 2009).

### ***Mid-2010s: re-regulation of rents in major cities (Germany)***

Recently, there have been strong political pressures to tighten rent control and rent increases in some cities where rents (and house prices) have been rising rapidly. In 2011 the cap on rent increases was reduced from 20 per cent within three years to 15 per cent over the same period. Then in autumn 2013, after the elections for the German Federal Parliament, the new governing parties, the Christian Democratic Union (CDU) and the Social Democratic Party of Germany (SPD), introduced a ‘Package for Affordable Building and Housing’.

One of the proposed measures was an introduction of new rent limits which came into force in 2015. This applies in different ways to existing and new tenancies. For existing tenancies, the *Länder* will determine districts with a tight rental market in which the rent cannot be raised by more than 15 per cent within four years instead of three. Furthermore, the amount that landlords can charge tenants for energy efficiency measures will be reduced from 11 per cent to 10 per cent per annum. This limit may render energy-saving refurbishments unprofitable in strong housing markets (where refurbishment cycles are shorter and the regulatory restriction becomes more binding) and in newer buildings (Henger and Voigtländer, 2011, cited in Lerbs, 2014).

For new contracts, a so-called rent brake (*Mietbremse*) came into force in mid-2015. Where it applies, initial rents on new tenancies cannot be more than 10 per cent higher than the reference rent (*Mietspiegel*) in the locality. The first letting of new constructed dwellings however is exempt. Each *Länder* may decide whether to impose these caps on new rents and rent increases; to date, they have been imposed in Berlin, Hamburg and many cities in Bavaria. About four million rental dwellings are located in such areas in Germany (Cornelius and Rzeznik, 2014).

It is too early to judge how these measures will affect the private rented market in Germany. The intention of the regulatory package is to acknowledge spatial differences in market developments and mitigate acute price developments in high-cost metropolitan housing markets (Kofner, 2014). Yet, in expectation of future rent caps, there is a strong risk of a significant increase in rents for new leases before the rent cap is introduced. Together with the limit on growth of future earnings, the expectation that more and more cities will apply the rent cap will reduce the incentive for landlords to invest in additional housing rather than other assets (Lerbs, 2014).

## 5.2 TOWARDS A SUBSIDY FREE SYSTEM?

Over the last two decades the German government has eliminated most of the subsidies for homeownership and rental housing. Today, Germany has the lowest level of direct and indirect housing subsidies in the group of developed economies – and the trend is further decreasing. However, Germany did not experience a housing crisis immediately before the global financial crisis of 2008. Part of this stability arises from relatively stable and sometimes declining house prices. Germany has no specific policies to favour the growth of owner-occupation and social renting. In fact, the conservative housing finance system (based on the use of buyer equity and fixed-rate loans with long maturities) dampens the households' incentive to enter homeownership and price volatility in the real estate market. The remaining instruments are rent control and rent regulation policies plus the taxation regime for rental properties that favours wealthier landlords which help to promote and sustain a broad, diverse and vital private rental housing sector (Weinrich, 2014).

### Private rental housing

#### *Tax treatment of private landlords*

##### *(i) Income tax*

German income tax law has seven categories of taxable income (PWC, 2013). Income from residential investments can be classed as business income (*Einkünfte aus Gewerbebetrieb*) or income from renting and leasing (*Einkünfte aus Vermietung und Verpachtung*). Rent received by individual landlords or partnerships is usually treated as the latter.

Up to 1998, landlords could deduct mortgage interest, allowances for depreciation and administration and refurbishment costs from taxable income (Westerheide, 2011). Since cutbacks in subsidisation in 1998, the deduction has been further limited to a maximum of 2% (Kirchner, 2007).

##### *(ii) Capital gains tax*

The tax treatment of profits and losses after a sale of a dwelling depends on the legal status of the owner. For a private individual, until 1999, capital gains from the sale of a residential rental building held privately for more than two years were usually tax-free. Today, the minimum holding period is ten years (Kemp and Kofner, 2010). If a property is sold earlier, the capital gains are fully taxed, while losses are fully deductible from other capital gains which are liable to income tax. For private corporations, this regulation does not apply: capital gains are always liable to corporate income tax, and losses are always deductible from the tax base (Westerheide, 2011).

##### *(iii) Treatment of depreciation for income or corporation tax*

German landlords, whether corporate or individual, are treated the same for income tax purposes (Hubert, 1998, p.219). This means that they may deduct their costs, including depreciation, from their rental income (Tomann, 1990). For properties built before 1925, the depreciation rate is currently 2.5 per cent for 40 years; for properties built after 1925, it is 2 per cent for 50 years. Tax relief on depreciation applies to all rented properties, and thus also to properties subsidised by bricks-and-mortar subsidies under the 2001 *WoFG*.



The depreciation scheme was established in 1953 (Haffner et al, 2009). Until the end of 2005, owners of *new* buildings could choose to depreciate them on either a linear or ‘degressive’ (higher deductions early on, lower later) basis. This degressive depreciation could be regarded as a form of tax relief that favoured new buildings. The federal government of Christian Democrats and Social Democrats that took office in November 2005 completely abolished the regressive depreciation with effect from 1 January 2006 (Haffner et al, 2009).

Housing acquired from the existing stock can be depreciated in a linear way. This depreciation has to be seen in connection with the fact that capital gains from the sale of private assets are not taxed. Following a sale, a building already written off can therefore be depreciated again, without affecting the seller’s profit.. Thus, it can be considered as indirect subsidisation, which favours old buildings (Kirchner, 2007).

A study compared the tax burdens of landlords and homeowners using the discounted cash-flow method in Berlin (Braun and Pfeiffer, 2004, cited in Haffner et al, 2009). It reported that landlords generally received more subsidies in the form of tax-deductible depreciation than owner-occupiers in the form of *Eigenheimzulage* when it came to new-build dwellings. The authors concluded that landlords could reduce rents substantially if they were to pass on the tax benefits to their tenants in full (instead of regarding it as additional profit). The decrease in rents could be as much as 20 per cent of the market rent, which would significantly affect the balance of user costs between the two tenures.

#### *(iv) Inheritance tax*

Inheritance tax is incurred on the intergenerational transfer of dwellings. The tax rates and the amount depend on the value that is transferred and on the relationship of the beneficiary to the deceased person. If the beneficiary is the spouse of the deceased person, a personal allowance of €500,000 applies. The amount above that level is liable to inheritance tax at a progressive rate between seven per cent and 30 per cent. If the beneficiary is a child, the personal allowance is smaller (€400,000), but tax rates are the same. If the beneficiaries are distant relatives (such as nephews), personal allowances decrease drastically (to €20,000) and tax rates vary between 30 per cent and 50 per cent. The tax base is 90 per cent of the capitalised rental value of the dwelling (Westerheide, 2011).

#### *(v) Property tax and property acquisition tax*

The annual property tax is 3.5 per thousand of the value of the property. However, the tax is not calculated on the basis of the transaction value but the so-called ‘standard value’ which reflects average property values from 1964 in West Germany and 1935 in East Germany. Property acquisition tax is a minimum 3.5 per cent of the transaction value and in some states up to 5 per cent (Westerheide, 2011).

## **Owner occupied housing**

### *Demand-side subsidies*

#### *(i) Subsidies for acquisition of existing housing as a form of pension*

Since 1 January 2008, the acquisition of owner-occupied and co-operative housing based on the Riester pension (*Riester Rente*) can be subsidised. The Riester pension is a state-sponsored pension scheme which has been in existence since 2002. Its aim is to increase personal pension provision, and it is being utilised for the acquisition of housing property. Between €10,000 and €50,000 from a person's accumulated funds can be used to build or purchase owner-occupied housing located within Germany (Ball, 2010). The borrowed amounts must be repaid back into people's pension funds prior to their retirement and the properties purchased must be occupied by them during their retirement. Repayments on approved mortgage loans (the so-called 'for the Riester pension certified' mortgage loans) used to acquire housing property are subsidised annually. Both amounts (repayment and subsidy) are counted as savings into a fictitious Riester pension account. Tax payment on this account is deferred until the 'official date' of usage has passed, for example, pension age. It is also possible to use funds saved for the Riester pension to acquire housing property for own usage (Oxley and Haffner, 2010).

#### *(ii) Mortgage tax relief*

There is no mortgage interest tax relief for owner-occupiers.

#### *(iii) Tax relief for down payment savings (Bauspar)*

Savings for down payments on purchases of owner-occupied homes are subsidised for some households under the 'Contractual Savings for Housing' (*Bausparen*) programme. The savings scheme itself is available to everyone. Money is deposited in special *Bausparen* accounts for a contractual period, and attract a below-market interest rate. When the contractual savings period ends the participant receives the balance in the account, plus an associated loan that must be used for house purchase or construction. This loan also bears a low interest rate. Savers with incomes below a certain limit receive an additional government subsidy. This was very generous in the past, but in 1990, this program was severely reduced. The maximum subsidy rate is now 10 per cent (Börsch-Supan, 1994).

#### *(iv) Other tax benefits*

Imputed rental income of owner-occupancy is not taxed in Germany. Germany has a negligible property tax, due to both low assessed values and low nominal property tax rates (Börsch-Supan, 1994). According to Lerbs and Oberst (2014), the effective property tax rate (defined as the ratio of the annual nominal tax burden to the market value of the house) averages between 0.1 per cent and 0.2 per cent.

## **Social rented housing**

In Germany, social landlords generally fall into one of two categories. About two-thirds are cooperatives (*Genossenschaften*) backed by community organisations such as charities, churches and trade unions; they control about one-third of the stock. The remainder is controlled by the limited liability housing companies (*Wohnungsgesellschaften*). Some are

controlled by municipalities and national employers, others by trade unions and churches. All these social landlords are regulated by federal law (Ditch et al, 2001).

### *Supply-side subsidies*

#### *(i) Before 2001*

Up to the end of 2001, the subsidisation of social housing construction was regulated by the Second Housing Law of 1956 (*II. Wohnungsbaugesetz*). Under the Second Housing Law of 1956, only bricks-and-mortar subsidies were granted. There were three different subsidy methods: the first and second subsidy methods, and the agreed subsidisation (the third subsidy method). In all three, both rented housing and ownership qualified for subsidisation.

Originally, there was only the *first subsidy method*. Housing built with these subsidies had to be rented at cost rents, which resulted in rent distortions between housing built in different years. Beneficiaries of the subsidies were required to use cost rents until the public loans had been repaid; the loan periods became increasingly shorter and now average between 30 and 50 years. The rules about tenant eligibility were uniform in all states. In the early stages, the income limits were so broadly framed that about three-quarters of the population had access to social housing. As a result of the irregular adjustment of income limits, the numbers of eligible people have fallen over the years. In 1999, only 37 per cent of households in the former West Germany had access to social housing supported by the first subsidy method (Kirchner, 2007).

The *second subsidy method* was introduced in 1965, and was aimed at households whose income exceeded the limits of the first subsidy method by up to 40 per cent. The lock-in periods, at 10 to 15 years, were significantly shorter than in the first subsidy method. In addition, this housing was subject to the cost-rent principle. One major motive for introducing the new subsidy method was that it would cover a greater number of dwellings, since the subsidy for each was smaller. The second subsidy method concentrated largely on owner-occupancy. 1981 saw the passing of the Act for the Reduction of Misdirected Housing Subsidisation, which allowed the states to charge an income-related compensation payment to households whose income rose beyond the income limits after they moved into social housing.

To make subsidisation more flexible and cheaper in individual cases, the *third subsidy method* (agreed subsidisation) was introduced in 1989. Eligibility requirements, rent levels, rent reviews, lock-in periods and subsidy amounts could now freely be defined by the states, without reference to cost-rent regulations. Following its introduction, the federal states developed a wide range of subsidisation programmes. Eligibility to housing built under these programmes was framed much more broadly than under the first subsidy method, and the lock-in periods were also shorter. The 1994 House Building Subsidisation Act incorporated modernisation into the Second Housing Law as a new criterion for subsidisation. Until that time, additional social dwellings could only be obtained by new construction.

#### *(ii) After 2001*

On 13 September 2001, the Second Housing Law of 1956 was superseded by the Housing Subsidy Act (*Wohnraumförderungsgesetz; WoFG*). This finally abolished the earlier subsidy methods and the inefficient cost-rent regulations. As a result, states are now responsible for housing subsidies. For housing subsidised under the old law by the first subsidy method, the

cost rent, however, remains in effect until expiry of the commitments. Under the old act, the aim of subsidisation consisted in providing housing for broad sectors of the population. Under the Housing Subsidy Act, subsidisation is to be concentrated on households who cannot find adequate housing on the market. The income limits specified in the Housing Subsidy Act correspond to those that applied under the old law in the first subsidy method. Under the new law, the purchase of existing property, the acquisition of occupancy commitments from existing stocks and the conclusion of contracts between municipalities and housing companies can also be subsidised, provided that this gives rise to occupancy commitments and rent restrictions in favour of the target households (Kirchner, 2007).

Since 2006, most of the 16 states run their own housing subsidy programmes. In many of the programmes subsidised loans from the KfW (*Kreditanstalt für Wiederaufbau*, a state-owned bank) are combined with additional state-specific measures, usually interest-rate reductions. These subsidies are available for special purpose investments, for example to supply housing for low income households and those facing particular difficulties to access suitable housing such as released prisoners, homeless people, etc. Other subsidies, such as for the refurbishment of the existing housing stock, energy saving measures or disabled access improvements are also available, but these are not exclusively available for rented housing (Westerheide, 2011).

## Homeowners and renters

### *Two systems of housing allowances*

In 2005, the social security system in Germany was comprehensively overhauled. The reform established two parallel systems of housing allowances that aim at mitigating housing costs for low or no income households. Low-income households can apply for *Wohngeld*, a housing allowance which pays part of rent depending on household income, costs and household size. Households with no or very low income receive social security transfers called *Grundsicherung* that cover all housing costs up to a level set by local governments. Table 5.1 shows the key characteristics of both systems.

**Table 5.1** Key characteristics of *Grundsicherung* and *Wohngeld*

	<i>Kosten der Unterkunft (KdU)</i>	<i>Wohngeld</i>
<i>Aim of the housing allowance</i>	Affordability of adequate living conditions	Affordability of adequate housing
<i>Target group</i>	No-income households	Low-income households
<i>Eligible housing costs</i>	Rents with heating, homeowner costs	Rents without heating, homeowner costs
<i>Method</i>	Full payment of eligible costs	Subsidy of eligible costs
<i>Rent/cost ceilings</i>	Yes, set by local municipality	Yes, differentiated into 6 classes

### *Housing allowances outside social assistance benefits: Wohngeld*

Housing allowances (*Wohngeld*) were introduced in West Germany in 1965 as a way of securing decent homes at affordable prices for low-income groups when the rental housing

market was gradually decontrolled. *Wohngeld* is a federal scheme, which is the responsibility of the states, but is actually administered by the municipalities on their behalf. The housing allowance is available to tenants in social and privately rented dwellings and to home owners. In 2011, 903,000 households have received *Wohngeld*, which equals two per cent of the total number of households. In this year, expenditures reached €1.23 billion with an average payment amount of €114 per household (Table 5.2).

**Table 5.2** Number of households receiving *Wohngeld* and the expenditures

	Households (‘000)	Expenditures (Billion Euro)	Average <i>Wohngeld</i> * subsidy per household (Euro)
2005	810.9	1.351	95
2006	691.1	1.094	91
2007	606.4	0.935	88
2008	639.1	0.726	88
2009	1,007.3	1.567	125
2010	1,061.5	1.761	126
2011	902.9	1.490	114
2012	782.8	1.183	114
2013	664.7	984	114

Source: Wohngeldstatistik, Kassenstatistik BMVBS; only households without Grundsicherung payments.

The allowances are either paid as a rent subsidy or a mortgage payment. The amount of support depends on the rent, the income and the size of one’s household. The higher the rent, the higher the subsidy; the higher the income, the lower the subsidy. This mechanism is built into the following formula which was originally derived from the rent-income-ratio in the 1990s (Huber, 1996; Wohngeldgesetz, 2009):

$$W = 1.08 * (M - (a + b * M + c * Y) * Y)$$

W = Payment amount

M = Eligible Housing Costs (Rent or home owner costs)

Y = Disposable household income

a, b, c = Parameters depending on the number of household members

The parameters in the formula differ with the number of household members. The formula is designed to ensure that the housing-cost burden is in the range of 15 to 30 per cent of disposable income. Subsidy never covers 100 per cent of the rent; the maximum proportion covered is 80 to 85 per cent. The formula also determines the income ranges in which the household types can apply for *Wohngeld*. The lower income bound is the minimum gross income at which disposable income (earned income – social security taxes + *Wohngeld*) equals the total requirement (*Gesamtbedarf*) of a household. The upper income bound is the maximum gross income at a level where housing allowance equals €10 (minimum amount paid).

After the Hartz reforms, the *Wohngeld* payments are financed fifty-fifty by the federal budget and the 16 state budgets. *Housing allowances within social assistance benefits: Kosten der Unterkunft (KdU)*.

Before 2005, tenants who received social assistance benefits (*Sozialhilfe*) qualified for payments to cover 100 per cent of their rents, net of service charges (Ditch et al, 2001). During the Hartz reforms in 2003–04, the ‘Hartz legislation’ extensively redesigned the social welfare system, particularly for the long-term unemployed in Germany (Fleckenstein, 2008). In 2005, new legislation (the Hartz IV law, the fourth piece of the Hartz legislation) came into effect which integrated the unemployment and social assistance schemes into one benefit scheme for the long-term unemployed. It significantly tightened the rules on benefit for the long-term unemployed and reduced the rent that is fully paid by the state. Now, Germany has a ‘two-step transfer system’ for the unemployed: in the first 12 months of unemployment (18 months for those aged 55 or over), the assistance is earnings-related ‘unemployment benefit I’ (*SGB I*); thereafter, it has no relation to previous earnings and is called ‘unemployment benefit II’ (*SGB II*).

From 2005 onwards, households who have no (or very low) income (*SGB II*) such as long-term unemployed or retired (*SGB XII*) receive *Grundsicherung*. In this new system, households are getting paid their housing costs to the full extent as long as the dwelling is appropriate. *Grundsicherung* includes all costs for housing, including heating. In 2012, 2.7 million households received *Grundsicherung*, which equals seven per cent of the total number of households (see Table 5.3). The payments were very constant over the last years, although the German economy has been remarkably hit by the crisis in 2009. Over the years since 2005, the number of households in receipt of these payments has declined by nearly 17 per cent, because Germany managed to reduce the unemployment rate. However, the average payment increased by 22 per cent, mainly because rents have risen in this period especially in bigger cities, where the number of people within the social security system is high. The *Grundsicherung* payments are financed by the municipalities, which in turn get some transfers from the federal budget.

**Table 5.3: Number of households and expenditures (*SGB II* plus *SGB XII*)**

	<i>SGB II KdU</i> recipients in millions	Expenditures for <i>KdU</i> in Billion Euro
2005	7.39	14.2
2006	7.99	15.8
2007	7.95	16.0
2008	7.54	15.5
2009	7.36	15.9
2010	7.36	16.1
2011	7.01	16.1
2012	6.82	16.0

Source: Statistik der Bundesagentur für Arbeit, Statistisches Bundesamt

*Grundsicherung* is only paid to those who do not receive other forms of income transfers like *Wohngeld*. The amount of eligible costs varies across municipalities. Unlike *Wohngeld*, the municipalities define the amount of the rents eligible for benefit.

### 5.3 SUMMARY

In general, subsidies and tax incentives are close to being tenure-neutral, except during 1997 to 2005 when a one-off subsidy programme was introduced to increase homeownership.

Immediately after the second world war, the focus of West Germany’s housing policies was to provide generous tax and loan subsidies designed to encourage construction of both private

and social housing, and also to stimulate the owner-occupied housing sector. At the same time, there was a gradual relaxation of government controls over rents. Initially, social housing was accessible to a broad range of the population. But gradually, the focus was limited to low-income households only. In addition to supply subsidies, rental housing allowances were introduced in 1965 for both homeowners and renters.

Starting from 1990 there were sharp reductions in the amounts of subsidies and tax benefits such as tax relief for down payments, depreciation allowances, and the corporation tax exemption for non-profit landlords. In 2001 the subsidy system for social housing construction changed and states are now responsible for housing subsidies. And in 2005, the regressive depreciation system was abolished and housing allowances for unemployed people reduced. Overall, after significant cuts in government expenditure, there is today very little subsidy to homeowners or landlords (private or social) in Germany.

Over the last several decades tenants have experienced a steady relaxation of rent controls, from frozen rents in the 1950s to cost rents and now freely-set initial rents and *Mietspiegel*-based rent rises. This relaxation never reached the full decontrol seen in England, for example, and recently the relaxation itself has been reversed with re-imposition of controls on initial rents in some high-cost cities. The PRS has always been more attractive to tenants in Germany than in many other countries. This reflects all the features of the rental offer – and the features of other tenures – rather than just rent levels or increases. All else being equal the tenant-friendly new controls on initial rents could be expected to boost demand in areas where they are applied, but pressure for change came about because of price rises for *all* tenures. This means that German tenants in these areas are now foregoing capital appreciation as owner-occupiers. This is considered self-evident in England, but has hitherto not been the case in Germany, where the conservative housing-finance regime and stable house prices have limited demand.

With reunification Germany experienced a seismic political change that had no parallel in the other three countries studied. Nevertheless, in the realm of housing policy on the whole the picture has been one of steady, incremental change; there were few fundamental shifts in direction. Those policy changes that might be expected to affect relative user costs for tenants, landlords and owner occupiers include

- 1954 rent law, allowing increases in previously frozen rents
- 1958 – 1971: gradual relaxation of rent control
- 1965: introduction of housing allowance
- 1971: introduction of comparable rents system
- 1976: tax concessions for owner-occupiers buying existing dwellings
- 1990 onwards: incorporation of Eastern Germany and its housing
- 1997 -2005: *Eigenheimzulage* subsidy for first-time buyers
- 2015: new initial rent limits in high-cost areas.

# Chapter 6: Drivers of change in the scale and role of the Dutch private rented sector

## 6.1 INTRODUCTION

Housing policy in the Netherlands, as in other countries, has gone through several stages since the Second World War. Boelhouwer and Van der Heijden (1992: 273) distinguish three stages in the period of 1945-1990. They are characterised by a high degree of government involvement in housing construction since 1945 with the aim to alleviate the housing shortage caused by the war; a greater emphasis on housing quality since 1975 brought more attention for the improvement of housing stock and urban redevelopment; and a greater emphasis on problems of housing distribution and targeting of specific groups and the withdrawal of the state in favour of the private sector since the late 1980s. The financial privatisation of the landlords in the 1990s led to a further decline of private renting. The aims of the present government are to focus social renting more on vulnerable households and extract funds from the sector, which may offer new chances for private renting – more specifically for the more expensive rental segment with deregulated or liberalised rents.

The aim of this chapter is to identify and trace the significance of some general political and economic changes that affected the supply and demand of private renting in the Netherlands over the last 60 years. The literature review charts these developments in four timeframes from 1945 onwards: 1945 – 1969, 1970 – 1988, 1989 -2009 and 2010 onwards. An overview of the fiscal instruments affecting the rental sector can be found in Table 6.1.

## 6.2 1945–1969: DECLINE OF THE PRS

Given the manifest housing shortages that appeared after 1945 in combination with large increases in the cost of living and construction costs as well as high interest rates, bricks and mortar subsidies for housing construction were (re)introduced in 1947 (Boelhouwer and Van der Heijden, 1992; Haffner et al., 2009; Van der Schaar, 1987; Whitehead et al., 2012). Subsidies were deemed necessary to safeguard housing construction, as rents were frozen until 1951 as part of the government's incomes policy (Elsinga et al., 2005; Haffner, 2002). In short, the private builders were not able to counter the housing shortage. Government took over. This choice heralded an era of far-reaching and long-term government involvement in housing.

Subsidies to social renting were distributed to non-profit public organisations, known as municipal housing companies which took the lead in constructing social rental dwellings in the first decades after the war (see Table 6.1) (Brakkee, 1997; Haffner, 2002; Nagel, 1986). They were also given to the non-profit private social landlords, called housing associations (*woningcorporaties*) which are special organisations registered under the 1901 Housing Law, and to investors in private rental dwellings (Boelhouwer and Van der Heijden, 1992). As much as 95% of all housing construction was subsidised. The method of subsidisation was adapted to the needs of the tenure. Given government budgetary limits, the focus was on cheap rental dwellings in large-scale projects.



In the 1950s and 1960s, the division of work between local authorities and housing associations was debated a number of times, but it took until the late sixties before the leading role in social rental housing construction was re-assigned to the housing associations under the 1901 Housing Act (Brakkee, 1997; Elsinga et al., 2005; Faber, 1997; Haffner, 2002; Nagel, 1986; Van der Schaar, 1987). Local authorities were only allowed to build dwellings when the associations were not able to do so. In 1967, the market share of dwellings owned by municipal housing companies was at its largest at 13%, while the share of housing associations amounted to 22%.

According to Elsinga et al. (2005) the Roos Committee in 1964 expressed the government's view that housing associations should be valued as a form of private initiative that is generated and maintained by independent social forces. Therefore, the associations were not limited to building housing that would not be profitable for commercial builders, nor to providing housing only for underprivileged groups; the expectation was that the co-existence of commercial developers and housing associations would stimulate optimal results (Elsinga et al., 2005). These conclusions led to the equalisation of criteria for supply side subsidies between social and private rented sectors in 1968, while at the same time housing associations were encouraged to take out loans on the capital market instead of loans from the government (see Table 6.1; Van der Schaar, 1987).

**Table 6.1 Financial instruments in the rental sector, 1945-2010s**

	Social renting			Renting (private and social)		
	Government loans	Government guarantees	Corporate income tax exemption	Bricks and mortar subsidy; included exemption of corporate income tax, if that was not already available for a landlord	Rent control	Housing allowance
1945	Yes		Yes	Yes	Rent freeze as part of wages policy	No
1960s	Yes, loans on capital market also encouraged	Municipal guarantees	Yes	Yes	Rent harmonisation	No
1970s	Yes + loans on capital market	Municipal guarantees	Yes	Yes	Introduction of the points system	Yes*
1980s	Yes + loans on capital market	Via WSW with central-local government backing	Yes	Yes	Rent liberalisation for new build	Yes*
1990s	Grossing and balancing: end of government loans	WSW: all loans	Yes	Abolition of loans for new construction; grossing and balancing for existing subsidy obligation	Rent pooling; rent liberalisation for existing dwelling and new contract	Regulated segment of rental market (as of 1989)
2000s	No	WSW: all loans	Partial as of 2006; none since 2008	No	Further liberalisation	Regulated segment of rental market
2010s	No	WSW: loans for social housing	Amendment of the corporate income tax law so that housing associations could no longer use an exemption	No	Differentiation according to environmental quality labels, scarcity areas and household income	Landlord levy for owners with more than 10 dwellings with a regulated rent (2013-2017)

\* Some limitations were in place too, mostly based on income and type of subsidized dwelling (Vander Schaar, 1987).

Sources: Bestuur Rendement (2012), Blok (2013a, b), Elsinga et al. (2005), Haffner (2014), Haffner et al. (2014), Ministerie van Binnenlandse Zaken en Koninkrijksrelaties (2013), Priemus (2014), Van der Schaar (1987). Local land subsidies for social housing not included (local choice)

Rental policy also underwent a change (Boelhouwer and Van der Heijden, 1992; Elsinga et al., 2005; Whitehead et al., 2012). Until 1955, rents had been strictly regulated and a big gap had arisen between the old stock with low rents because of regulation and the new rental housing with high rents. The resulting limited mobility in the rental market was regarded as

undesirable. In 1967, it became possible to raise the rent of existing accommodation for a new tenant and charge the average rent of subsidised new build housing.

The focus on social renting in combination with relatively strict rent regulation led to the decline of the private rental sector (PRS) after WWII. The share of private rental housing stock fell from 60% in 1947 to less than 30% by the end of the 1960s, as can be observed in Figure 6.1. This decline was largely the result of the significant fall in number of properties owned by individual landlords, while the share of those owned by organisations remained stable. The fact that any subsidies for construction that were available were most likely taken up by organisational landlords (including housing associations) and not by individuals, must be part of the explanation of these developments. The effect of a growing owner-occupied sector was slight as it scarcely increased from 28% in 1947 to a little over 30% by the end of the 1960s.

Another reason for the decline of the PRS was the poor quality of the pre-war stock which could often be sold off to sitting tenants, local authorities or housing associations rather than incur additional expenditure. The process of decline was aided by the relatively low returns from renting as a result of rent control and tenant protection (indefinite rental contracts plus a narrow range of reasons for eviction from rental dwellings). In addition the introduction of a state pension reduced the reliance on rental investment to provide for old age income (Adriaansens and Priemus, 1986; Boelhouwer and Van der Heijden, 1992; Priemus, 1998).

### **6.3 1970-1988: SHIFTING REGULATION AND SUBSIDY; THE FURTHER DECLINE OF PRS**

The 1970s saw considerable change in the regulatory and subsidy framework and continued decline in the PRS. In terms of regulation the average rent of subsidised new build dwelling was no longer regarded as a good benchmark (Van der Schaar, 1987: 128) and it was recognised that an objective quality criterion should be included. The result was the introduction of a points system per dwelling unit which included quality as well as quantity attributes (Priemus, 1998). Each unit received a total number of points and a maximum rent was set for each point (see Table 6.1).

The bricks and mortar (supply) subsidy system, which was relevant for social and private landlords, was also under review in this period (Table 6.1). The question was classical: whether it would not be more efficient to subsidise low-income tenants rather than the construction of dwellings. This led to the introduction of a housing allowance scheme in 1970, with the objective of making sure that housing remained affordable while allowing rents to be raised to cover landlords' costs. The housing allowance was intended to be a temporary measure, to give tenants time to get used to paying higher rents. However, the two oil crises made the affordability of housing a political issue again, and both the supply subsidies and the housing allowance were maintained.

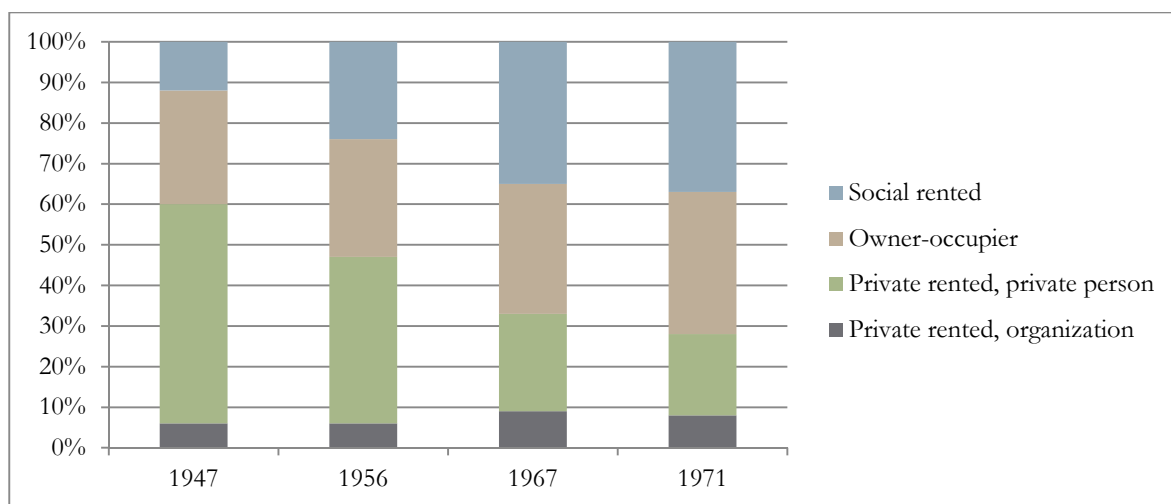
The position of housing associations also started to change in this period. Housing associations moved towards financial independence from government in the 1990s as government loans were replaced by capital market loans (Haffner, 2002; Priemus, 1995; Table 6.1). To help facilitate the financial independence of housing associations, a mutual fund – a private guarantee institution, still in place today as the Mutual Guarantee Fund for Social Housing (WSW) – was established in 1984 to promote the rehabilitation of post-war housing (Table 6.1; Haffner 2002). The housing associations contribute voluntarily to this

Fund, if they want their loans to be guaranteed by it. The guarantee covers the risk of non-repayment of the loans for the lenders. If the WSW has insufficient funds to fulfil the guarantee to the lender, the state and the local authorities, as the next layer of guarantee, back-up to this fund in equal shares. Because the risk to lenders is reduced by the double guarantee (which can be considered as subsidy), the cost of borrowing is reduced as compared to the situation without a guarantee.

The bricks and mortar subsidies were given as an annual revenue or management subsidy for 50 years when the dwelling was constructed. For the period up to 1989, this subsidy system and its changes were relevant to both social and private organisational landlords – although not to individuals. Figure 6.2 shows that the share of private organisation landlords remained relatively stable, as they took advantage of this bricks and mortar subsidy for new build rental housing which had been introduced in 1968 (see above).

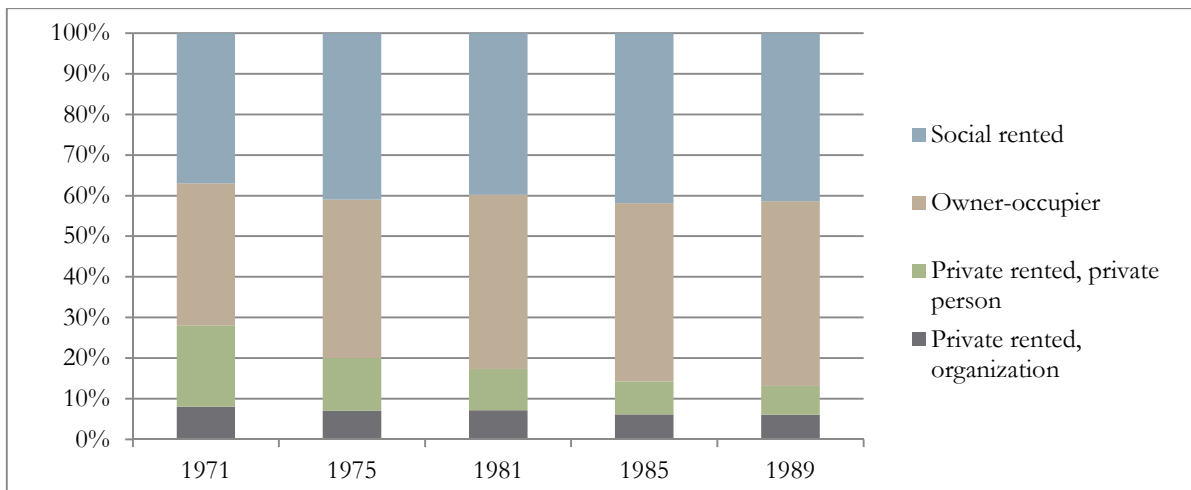
As housing associations did not pay corporate income tax, a tax exemption called article 10 of the corporate tax code was introduced. Article 10 was available for corporate tax paying organisations investing in rental dwellings (mainly insurance companies, as pensions funds were exempted from corporate income tax) to create a tax exemption for the income from the rental dwellings that were built with bricks-and-mortar subsidies. A financial level playing field was created for housing associations and private organizational landlords when they financed investment with bricks and mortar subsidies. However, as the bricks and mortar subsidy system had undergone review and became less attractive progressively, the share of organisation private landlords started declining slowly as well (to 6% in 1989, from 8% in 1971). This slight decline probably occurred because of the business model of these organisations which involved the sale of dwellings after 15 or 20 years before large investments in renovation became necessary (Priemus, 1998).

**Figure 6.1 Tenure distribution in the Netherlands, 1947-1971**



Source: Van der Heijden et al. (2002).

**Figure 6.2 Tenure distribution in the Netherlands, 1971-1989**



Source: Van der Heijden et al. (2002).

All government support for bricks and mortar described so far were taken up exclusively by organisations, not by individual landlords. As a result, while the share of private organizational landlords declined only slightly during the period 1971-1989, the share of the PRS declined more steeply from 28% in 1971 to 13% at the end of the 1980s. Individual landlords continued to sell off their property (often in urban renewal projects; see above) and their share dropped from 20% in 1971 to 7% at the end of the 1980s.

Owner-occupation, on the other hand, increased from 35% in 1971 to 45% in 1989 and became the largest housing tenure in 1981, while social renting remained relatively stable at 40% during this period. The introduction of the housing allowance in the 1970s played a decisive role in developing a dual-tenure structure based on income. Housing allowances and regulated rents made renting attractive for low-income households, while high-income households increasingly chose to become owner-occupiers, because of the favourable tax treatment which made and still makes paying higher rents unattractive (Haffner, 2002; Haffner and Boumeester, 2010; Haffner and De Vries, 2010).

#### **6.4 1989–2009: PRIVATISATION SRS, BUT FURTHER DECLINE OF PRS**

Government policies throughout the 1980s had demonstrated an increasing trend towards privatisation and promoting responsible private actors. The increased spending for ‘social engineering’ in housing on the other hand came to be seen as unaffordable. These developments culminated in the formulation of the White Paper of 1989 (Ministerie van Volkshuisvesting en Ruimtelijke Ordening, 1989; taken from Haffner et al., 2014) which heralded a new era in housing policy setting out a greater role for market forces, as well as the intention to reallocate responsibilities and financial risks away from government.

For the social rental sector (SRS) in the form of housing associations, the trend towards financial independence was continued, while the municipal housing companies were mainly taken over by housing associations (Elsinga et al., 2005, and Haffner, 2002). To increase financial independence of the housing associations, the WSW was extended to new

construction as of 1989 (Table 6.1)<sup>3</sup>. This allowed the central government (although not necessarily local authorities) to stop providing guarantees on new capital market loans taken out by housing associations for construction and renewal (Papa, 1992).

The final step in ensuring independence was taken in 1995 for the social rented sector and in 1998 for the PRS, respectively (Elsinga et al., 2005; Haffner, 2014). The so-called grossing and balancing operations involved the trade-off between the future subsidy obligations and the government loans that were outstanding in the social rented sector. The subsidy obligations originally specified for 50 years from the time of construction were re-calculated as net present value per rental tenure and paid to the social and private landlords, respectively. This operation resulted in the termination of government subsidies to both social and private landlords.

The cutting of financial ties between government and the rental sector went almost hand in hand with the creation of a liberalised rental segment in both the private and social rental markets from 1 July 1989 (for new construction) and 1 July 1994 (for existing dwellings). The result was a two segment sector (both in the PRS and SRS). A threshold rent level separates both segments, the one where rents are regulated and the one where rents are not regulated but negotiated between landlord and tenant. It is up to the landlord to decide whether to liberalize rent, given the number of points for the dwelling (which indicates a maximum rent allowable) is sufficient, once a new tenant moves in. Housing allowances were and are only available in the regulated segment (Table 6.1).

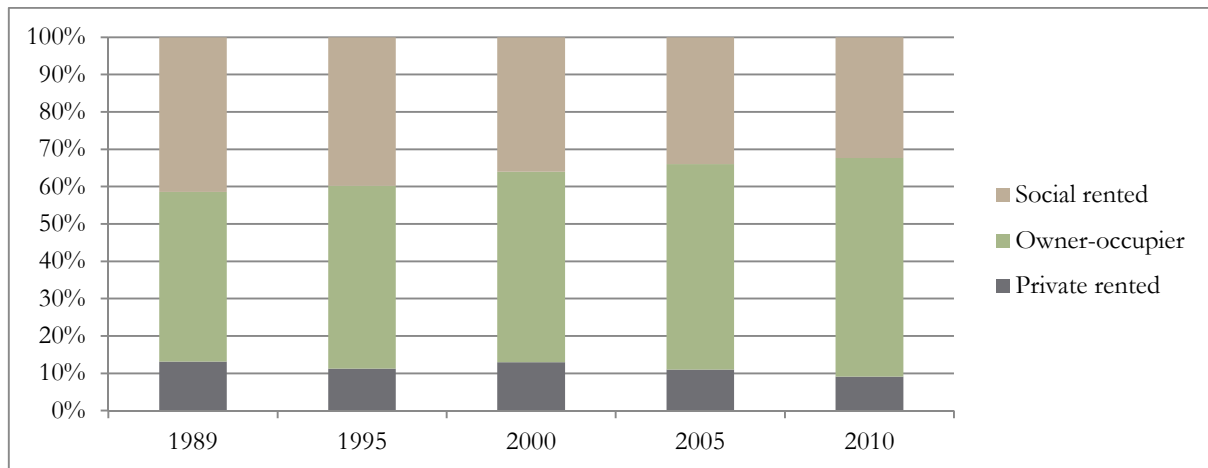
To summarise, in the 1990s, many of the main instruments that boosted the growth of homeownership and the SRS were kept largely intact (tax relief for homeowners with a mortgage, rent regulation and housing allowances for tenants; government guarantees for capital market loans for housing associations), and the country still had the largest SRS in the European Union (Haffner et al., 2014). The direct involvement of government in housing, however, faded with the abolition of bricks and mortar subsidies for new construction of rental dwellings and the capitalisation of remaining subsidies into one-off payments to organisational landlords. Direct involvement was changed to a more indirect governance of housing through a policy framework within which local authorities, social landlords and private actors had to operate.

These changes resulted in the continued stabilisation of the stock of social rental dwellings, while the stock of private rental dwellings decreased in absolute numbers. In relative terms, both tenures were decreasing (Figure 6.3) because of a steady growth in owner-occupation. Economic growth in combination with low interest rates in the 1990s and the relaxation of mortgage requirements boosted the growth of homeownership (Haffner and De Vries, 2010).

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<sup>3</sup> Social landlords finance their investments mostly with loans from the so-called sector banks, the BNG Bank and the Dutch Water Board Bank (NWB Bank; Oxley et al., 2015).

**Figure 6.3 Tenure distribution in the Netherlands, 1989-2010**



Sources: Van der Heijden et al. (2002) for up to 2005, Haffner et al., 2009; for 2010, ABF Research B.V. Syswov 2010, 13 June 2013.

When the subsidies for new construction were reduced sharply after 1989 and phased out completely by the end of the century, large capital gains as a result of rising house prices in the 1990s must have partly compensated institutional investors (Haffner, 2011). The share of investors remained relatively stable over the period 1947-1993 at around six percent of stock, and declined thereafter. Because of the abolition of the bricks-and-mortar subsidies and the more strict requirements of the Dutch central bank, institutional investors increasingly switched from direct to indirect investment after 1996 when about 75 percent of the investments of pension funds were direct. By 2008, the share fell to around 30 percent (Vereniging van Institutionele Beleggers in Vastgoed, Nederland, 2010). This was partly the result of their business model (see above) and the fact that they were not replacing sales by acquisition or the construction of dwellings.

In addition to the abolition of subsidies for new construction, the favourable tax treatment (tax exemption) via article 10 of the corporate tax code for institutions investing in subsidised rental dwellings was abolished for new construction in 1992 and for the existing stock in 2004 (Vereniging van Institutionele Beleggers in Vastgoed, Nederland, 2004). Total returns on residential investment (as measured by IPD) plummeted and turned negative after 2007, when the Global Financial Crisis (GFC) started. Negative capital yields are the main explanation here. Direct returns declined slightly in the period 1995-2009 (Vereniging van Institutionele Beleggers in Vastgoed, Nederland, 2010). This decrease was mainly the result of rising house prices. This made investors more dependent on capital gains, which in turn explains their business model to sell off dwellings before any large new investment has to be made.

At the end of 2008 house prices started falling as a reaction to the GFC hitting the housing market. New construction also went down and the number of transactions in existing dwellings also fell. The Dutch financial market was also hit (Haffner et al., 2014; Bijlsma and Suyker, 2008). Halfway through 2008, Dutch banks had to write off 15 billion Euro of debts which were linked to American securities. The Dutch government invested five percent of GDP (30 billion Euro) in the affected banks and insurance companies. It also gave guarantees to financial institutions up to the amount of 200 billion Euro. Because of the collapse of the banking system, banks had to improve their financial position (e.g. increasing capital

requirements according to Basel III) resulting in stricter credit requirements in all credit markets (Boelhouwer, 2013; De Jager, 2011). In 2009, the government intervened in the housing market with measures aiming at countering the effects of the GFC (Koning and Mulder, 2012; Van der Heijden et al., 2011). However, these measures have not succeeded in calming the housing market, as the Dutch economy ran into the third recession since the start of the GFC ([http://www.joop.nl/economie/detail/artikel/19560\\_nederland\\_weer\\_in\\_recessie/](http://www.joop.nl/economie/detail/artikel/19560_nederland_weer_in_recessie/); 9 May 2014).

## **6.5 2010 ONWARDS - NEW OPPORTUNITIES FOR THE PRIVATE RENTED SECTOR?**

As a reaction to the crisis the Conservative-led government that came into power at the end of 2012, announced huge budget cuts that aimed to meet the European Union agreement on a three percent budgetdeficit ceiling. Stepped reductions in the favorable tax treatment of owner-occupied dwellings were introduced in 2013 and 2014 and in 2013 the so-called landlord levy was introduced for landlords operating in the regulated rental sector (Table 6.1; Haffner et al. 2014; Centraal Planbureau, 2012a, b; Priemus, 2014). The aim of the levy was to extract funds from social landlords to help solve government budget problems (by paying for rent allowances). However, the levy not only applies to social landlords but also to any landlord owning more than ten dwellings with a regulated rent. The landlord levy is an annual tax with increasing rates until the year 2017.

The landlord levy was to go hand in hand with larger permitted annual rent increases in 2013 and 2014 for households with higher household income to help the landlords with regulated stock produce the cash flows necessary to pay for the tax. Tenants with a household income under €33,614 faced a maximum increase of 4%. For tenants with household income between €33,614 and €43,000, the percentage increase allowed was 4.5% and for tenants that earn more, the percentage increase was 6.5%. The percentage increases are set yearly by the minister (Haffner et al., 2014).

The net effect on returns of these measures (higher rents but increased tax on landlords), may hamper growth in the regulated rental sector. On the other hand, a number of policies have been introduced or are planned to be introduced that should create new opportunities for the PRS and especially for the deregulated segment.

Changes in policy intentions can be seen starting in 2010, when the then new coalition government of Conservatives and Christian Democrats aimed to shift the Dutch housing system towards 'more market' decision-making, leaving a more marginal social rental sector focusing solely on those in need. When the government fell in April of 2012, the only proposal that had been accepted by Parliament was to revise rent assessments to take more account of the popularity of dwellings: in higher pressure areas where dwellings are scarce a number of points will be added, allowing for higher rent levels when new tenants move in (Haffner et al., 2014)<sup>4</sup>. This occurred at the same time as income-dependent rent increases were implemented (see above).

Another policy that may affect the demand for private rental housing positively is the

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<sup>4</sup> The central government aimed to replace these scarcity points and the points for the type of by 1 October 2015 with the economic value of the dwelling that is used for tax purposes (<http://www.rijksoverheid.nl/onderwerpen/huurwoning/puntensysteem-huurwoning>; last accessed 17 June 2015). The aim is a more market conforming rent setting.



household income limit that was set for the allocation of social rental dwellings based on European Union state aid legislation (Elsinga et al., 2008; Tasan-Kok et al., 2013). According to the agreement between the Dutch government and the European Commission, housing associations are to allocate at least 90% of their vacant homes to households with a certain maximum income (€33,614, see above) since 2011. The income limit is in line with present government's ideas of a more targeted social sector and a better balance on the rental market with higher yields for investors in rental housing with deregulated rents (Haffner et al., 2014). By 2015, the Parliament had accepted the changes to the Housing Law, including even stricter rules about household income limits for housing associations to be introduced from 1 July 2015 (Ministerie van Binnenlandse Zaken en Koninkrijksrelaties, 2015).

These changes in rent regulation represent some movement towards taking account of market pressures (IMF, 2015). In addition in April 2014, the government proposed a rent freeze at €699.48 (later increased to €710.68 in 2015) on the maximum rent) that could be charged in the regulated segment of the rental sector (i.e. on dwellings with fewer than 143 points). The intention was to freeze rents for a three-year period starting in 2015, but the freeze will now be effected in 2016 (<http://www.rijksoverheid.nl/nieuws/2014/11/18/liberalisatiegrens-vanaf-2016-bevroren.html>; last accessed 16 June 2015). This freeze has the potential to shift additional properties into the market segment by undertaking improvement in order to increase the number of points applied to the dwelling – or to transfer dwellings with more than 143 points but with a regulated rent into the deregulated segment, when a new tenant moves in (see above; Oxley et al., 2015). Finally, the government announced a new rent pooling system but this has not yet been introduced. The system of income-based rent increases in the regulated sector will therefore continue.

## **6.6 FACTORS AFFECTING TENURE DECISIONS BY LANDLORDS, TENANTS AND OWNER-OCCUPIERS**

From the point of view of landlords and owner-occupiers one of the most important factors that affects investment is the tax framework in which they must operate. The system in the Netherlands differentiates not only between landlords and owner-occupiers but also between different types of landlord (notably between organisations and individuals, the scale of activity, the form of income and the type of loan. As a result there are different incentives with respect not only to tenure choice but also the means of financing that choice.

The framework is as follows:

### *Income tax for individual and corporate landlords*

Personal and corporate income tax generally treat housing income as income from investment, but the calculation of tax is done in four different ways: two for corporate landlords and two for private individual landlords with some variations (Haffner et al., 2009; taken from Haffner, 2011 and Haffner et al. 2014).

- (1) Organisational landlords in principle pay corporate income tax. Revenues (including capital gains) are subject to tax but costs can be deducted. Fiscal depreciation is however limited (Zwagemakers, 2008<sup>5</sup>). These professional landlords (companies) are subject to

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<sup>5</sup> Zwagemaker (2008) explains that fiscal depreciation has become almost non-existent for dwellings since 2007, because it is only allowed when the actual value of investment property is higher than 100% of WOZ-value.

corporate tax of 20% on profits up to €200,000 and 25% on amounts of profit above that amount. This tax regime has also applied to social landlords since 2008.

- (2) Two kinds of organizations are exempt from corporate income tax: pension funds and institutions that invest exclusively in real estate provided they pay a dividend to shareholders (Elsinga et al., 2007; Hoekstra, 2010). The latter are called Fiscal Investment Institutions (Dutch acronym FBI) and are similar to Real Estate Investment Trusts (REIT).

Private individual landlords are also taxed in two ways: either as more or less professional entrepreneurs or as investors in rented housing.<sup>6</sup> In practice the tax inspector decides which regime applies.

- (3) ‘Professional’ individual landlords are treated as running a business and must pay personal income tax like any other business subject to personal income tax. They are taxed on actual income (including capital gains) net of costs against a progressive tax rate (52% being the highest rate). The ‘real professionals’ (defined as those landlords who spend at least 1225 hours per year on their business and are under 65) benefit from an entrepreneur’s deduction depending on the profits achieved. Professionals who spend less time on their business are not eligible. Briene and Hulsker (2002) have calculated that returns to ‘real professionals’ are 0.2% higher after tax than for category (4) landlords.
- (4) Individual investor landlords are taxed on property income in the same way as owners of other personal wealth. Since the tax reform of 2001, imputed rather than actual returns have been taxed (Haffner, 2002). The net<sup>7</sup> total return is imputed as 4% of the market value of the property corrected for debt (net wealth). This net imputed return is then taxed at 30%, giving an effective tax rate of 1.2% on net wealth. Landlords’ actual income and costs do not affect the calculation. This also means there is no separate capital gains tax –if the dwelling is sold and the equity put into a savings account, the amount of income tax to be paid will not change.

### *Income tax for owner occupiers*

An owner-occupied dwelling is part of personal wealth and the returns from this wealth—in the form of imputed rent—are taxed in much the same way as the income from second homes or other wealth such as savings accounts or stock (Haffner et al., 2014). However imputed rent is taxed only during the period that mortgage interest is being deducted (maximum of thirty years). The amount of imputed rent taxed can never be higher than the amount of interest deducted. The tax rate is progressive and amounts to 52% at the most. The fact that imputed rent is then not taxed when the mortgage loan is repaid, or is only partially taxed if it

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WOZ-value is market value used for income and property tax purposes estimated each year, but lagging behind one year. The measure was taken as a measure to save money for the government.

<sup>6</sup> For director-large shareholders, there would be a different personal income tax treatment applicable.

<sup>7</sup> The net rate implies notional cost deductions.

exceeds mortgage interest, is considered a tax expenditure in the Budget of 2011 by Dutch government.<sup>8</sup>

Contrary to interest on loans for the acquisition of other personal wealth, mortgage interest as such is deductible in the Netherlands. To put in place the huge budget cuts that aimed to meet the EU-agreement of a maximum 3% deficit, the previously favorable tax treatment of owner-occupied dwellings was reduced (Haffner et al., 2015). As of 1 January 2013, the mortgage interest deduction is now only available for new mortgage loans with a loan term of 30 years and with an annuity or linear loan repayment structure. From January 2014, the marginal tax rate of 52% for the mortgage interest deduction is being decreased by 0.5 percentage points per year until it reaches 38% in 2040.

Owner-occupiers with an endowment loan also benefit from a tax exemption on savings tied to the future repayment of the mortgage loan with those savings. For new mortgagors, the endowment loan will no longer be attractive as the mortgage interest deduction will not be available as there is now a requirement that the loan be repaid regularly (by annuity or linear).

The overall system benefits mortgagors as compared to outright owners. The treatment of imputed income tax also favours owner-occupiers. Certain types of investor also benefit. However these differences may be relatively unimportant as compared to issues around rent regulation, access to social housing and the history of subsidisation both with respect to supply and demand.

In this context the major changes in policy that could be expected to have affected the tenure decisions made by tenants, owner-occupiers and/or landlords are:

- 1967: Rents could be raised on new tenancies (to average for subsidised new-build);
- Late 1960s: Housing associations assume major role in new housing construction, including for market homes;
- 1968: Bricks-and-mortar subsidies made available equally to social and private landlords; tax exemptions for corporations investing in rented homes;
- 1970: introduction of housing allowances;
- 1989: liberalisation of rents for new dwellings at top of market followed in 1994 by rent liberalisation for higher valued existing units when the tenancy change;
- 1990s: ‘grossing and balancing’ operations—government wrote off both social and organisational landlords’ debts and paid them the present value of the future subsidy commitment, then stepped back from direct support;
- 1992: tax exemption for corporate landlords removed for new construction and for existing stock in 2004;
- 2011: State aid considerations meant that social landlords must largely focus on low-income tenants;
- 2013: landlords permitted to impose higher rent increases on higher-income tenants in the regulated sector; landlord levy imposed on all landlords owning more than 10 dwellings with regulated rents.

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<sup>8</sup> Rijksoverheid, ‘Rijksbegroting 4. Toelichting op belastinguitgaven’ ([http://www.rijksbegroting.nl/2011/kamerstukken.2010/9/14/kst147870\\_4.html](http://www.rijksbegroting.nl/2011/kamerstukken.2010/9/14/kst147870_4.html); last accessed on 5 February 2013).

## **6.7 SUMMARY: TOWARDS A DUAL RENTAL MARKET: THE GROWTH OF THE DEREGULATED RENTAL SEGMENT?**

The PRS in the Netherlands has shrunk enormously in the post-war period, even though one could speak of a tenure neutral subsidy policy between social and private renting. As a result the Netherlands has one of the smallest sectors in Europe.

For many decades, organisational (in particular institutional) investors did not reduce their market share even though rents were heavily regulated. However, many individual landlords sold off their stock. In more recent years, even institutional landlords are no longer finding the returns from renting adequately attractive. Their market share has basically decreased in line with reductions in and then the abolition of bricks-and-mortar subsidies. On the demand side, the subsidisation of homeownership via income tax has driven down the demand for private renting especially among higher income households. The favourable tax treatment reduces housing costs, while since the abolition of the corporate income tax exemption, all other owners are liable for some type of income tax (except for pension funds; Haffner, 2011; Haffner et al., 2014).

From the point of view of tenants rent controls and housing allowances make the regulated part of the market attractive. However above the threshold tenants must pay market rents and are not eligible for housing allowances - so the choice between renting and owning is more clearly market based – but with significant tax benefits to owning particularly with a mortgage. A big issue is therefore whether they are able to access credit. Equally as the social sector targets assistance more towards more vulnerable and poorer households there are fewer opportunities further up the system.

Following on from the GFC and the subsequent recession, with falls in house prices and construction costs, tighter loan regulations, stricter allocation of social rental dwellings and more-market oriented rent regulation, the signs suggest that increases in demand for private renting might be enough to induce more supply in the PRS. One cross-sectional data source shows that the PRS on 1 January 2012 was, at about 140,000 dwellings, larger than it had been in 2009 (Blije et al., 2013). Some of these extra dwellings may be owner-occupied units which could not be sold as a result of the impact of the GFC on the Dutch housing market, and are thus only temporarily let out.

Looking to the future however, with the landlord levy in place until 2017 and an uncertain future thereafter, the continued expansion of the PRS is still questionable. The landlord levy may induce private landlords to leave the regulated sector and it may also induce a transfer of regulated dwellings to the unregulated segment. The net effect is unclear, but it is possible that the government's aim of a more market oriented system and a larger share for the medium-priced segment of the rental market may become reality.

## Chapter 7: User costs as a tool to analyse incentives in the private rented sector

This chapter discusses the definition of user cost, the construction of user-cost formulae and the questions that user-cost analysis can illuminate. In the next chapter we then introduce the results of our user-cost calculations for private renting in each of the four countries. In this report we employ user cost analysis as a tool to understand what motivates household tenure choice, and by implication what motivates property owners to invest in rental properties.

### 7.1 USER COSTS – WHAT ARE THEY?

‘User cost’ is an economic concept that attempts to encompass both the financial and opportunity costs of particular decisions or purchases. Although the word ‘user’ might suggest that the analysis focuses on consumer choices, in fact it is equally applicable to decisions by producers or investors (who in this context are ‘using’ their capital or other resources).

In order to understand the dynamics of housing tenure, we need to look at the fundamentals of the demand for and supply of housing in two tenures: private rental and owner occupation<sup>9</sup>. These are clearly conditioned by price or cost: rational consumers can be expected to try to minimise the cost of securing accommodation. Put simply, the housing expenditure for rented housing can be thought of as the monthly rent, and the housing expenditure for owner-occupation as the monthly mortgage and other housing payments. But these are just cash-flow measures; a full *economic* measure of cost would include the opportunity cost of investment foregone as well as expected capital gains.

These factors are all captured in the concept of the ‘user cost’ of housing, developed by US economists to express the full economic burden of housing on the consumer. User cost has been employed in various economic models that attempt to explain the performance of the market for owner-occupied housing; the most cited author is J. Poterba, who developed the user-cost approach to analyse how high inflation and mortgage-interest deductibility interacted to increase US house prices (Poterba 1984). As Miles states, ‘the best way to evaluate how the tax system, financial markets and housing markets have combined to generate incentives to owner-occupation is to evaluate the user costs of owner-occupied housing’ (1994, p.56). User cost is less frequently employed in analyses of rented housing and indeed, some of the user-cost literature is almost silent on the subject of renting. Even so, the fundamentals of user-cost analysis can in principle be applied to any tenure.

Clearly the use of any model or formula requires abstraction, but economists argue that models are nevertheless valuable tools. Miles (1994) says, ‘The reliance on formal models itself warrants some justification. Mine is simple: without a clear framework within which to analyse the determinants of the prices and quantities of houses it is hard to see how the implications of the distinctive features of houses, and of changes in them, can be assessed’ (p.

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<sup>9</sup> We have excluded social housing from the analysis because we want to focus on the *choice* between purchasing and renting. In many countries the allocation procedures for social housing mean households have to wait for months or years before securing accommodation. Those who need or want a different home in the short term therefore face an effective choice between renting privately and buying, even though some (tenants in particular) may eventually aspire to live in social housing. Co-operative housing is also a significant tenure in Denmark but is not similarly important in England, Germany or the Netherlands, so is not discussed in the analysis.

9). It is also important to set out clearly what the assumptions are, particularly about whether or not the system is in equilibrium, in order to identify which factors matter and why.

## 7.2 HOW ARE USER COSTS FOR OWNER-OCCUPIERS CALCULATED?

The basic version of the user-cost equation sets out the financial and economic costs of housing to the home owner. A simple user-cost formula is:

$$1) \quad uc_t = p_t[T_p + u + d + r - E_t(p_t)]$$

where

$p_t$  = price of dwelling at time  $t$

$T_p$  = property tax rate

$u$  = insurance, repairs and maintenance (constant % of home value)

$d$  = depreciation

$r$  = real interest rate

$E_t(p_t)$  = expected real increase in capital value at time  $t$

(derived from Miles 1994)

Here, the annual user cost in year one is the price of the house multiplied by the tax rate, maintenance expenditures, depreciation and interest payments, less expected capital gains-- which seems fairly intuitive. The assumptions are that property tax, expenditures on maintenance, depreciation and interest paid are all constant fractions of the house price; this equation does not deal with the complexities of financing the purchase. Note that this is the annual user cost as expected *in year one*—but user cost will not be constant over time because interest rates and other variables may change, and importantly because the concept is based on the housing investment without regard to the method of financing.

The formula can be refined in various ways to make it more precise and to more accurately reflect the financing of the investment, the individual national contexts, and the literature contains many examples. Here, from Lunde (1998, 2013), is a more complex formula that takes account of the method of financing of house purchase (the split between debt and equity) and some specifics of the Danish system. He defines user costs for owner-occupied housing in period  $t$  as

$$2) \quad uc_t = E_t i_{E,t} (1 - T_{E,t}) + F_t i_{F,t} (1 - T_{F,t}) + K_t (d_t + q_t + a \cdot g T_t + e_t - p_{ej,t})$$

where  $E_t$  is the equity invested in the dwelling

$i_{E,t}$  is the rate of return on equity

$T_{E,t}$  is the taxation on a similarly leveraged alternative investment

$F_t$  is the borrowed amount invested in the dwelling

$i_{F,t}$  is the interest rate on the loan

$T_{F,t}$  is the tax rate for negative interest income with which interest expenditures on loans are offset in taxable income

$K_t$  is the market value of the property at the start of/end of the period

$d_t$  is administrative, operational and maintenance expenditures.

$q_t$  is the rate of depreciation.

$a \cdot g T_t$  is the land tax ( $a$  is the public assessed land value's part of the market value and  $g T_t$  is the land tax rate)

$e_t$  is the property value tax rate

$p_{ej,t}$  is the rate of price increase for the property if quality is unchanged.

The first two elements of the formula represent the opportunity cost of capital invested and the debt financing of the dwelling purchase, while the final element is similar to the simple formula presented earlier. The specifics of this formula reflect the Danish situation: land and built property are taxed differently, so the land tax and the tax on the value of the full property are identified separately in the formula. This is not the case for instance in England and there is no way in the British context to separate the value of the land from the value of the building.

Lunde points out that ‘taxation conditions influence user cost, (so) the relevant national user cost concepts will vary by country’ (2013, p. 5). This suggests that it may be necessary to specify separate user-cost formulae for each country, as a single formula that covered all cases would be too unwieldy.

### 7.3 HOW ARE USER COSTS IN THE RENTED SECTOR CALCULATED?

The determination of user costs for tenants is simple: ‘for rented dwellings the tenant’s housing expenditure—the rent—is approximately equal to the user cost’ (Lunde 2013). In principle, in a free market in equilibrium, the marginal rental income received by the landlord<sup>10</sup> and the marginal cost to the tenant (rent) are the same. Thus under equilibrium these conditions, calculating user cost for landlords on a similar basis to that for owner-occupiers should allow us to derive rents. The formula would have to be modified to take into account the specific tax and benefit circumstances of landlords. At the limit the formula for landlords would demonstrate that in equilibrium, the landlord would charge a rent equal to marginal cost of supply (user cost). However none of our housing markets can be said to be in equilibrium at any point in our estimation period so we can only look at the landlord position by evaluating whether the scale of the sector is increasing or decreasing. Here therefore we concentrate on comparing the position of owner-occupiers with that of tenants.

### 7.4 FORECASTING

Much of the user-cost literature—e.g. calculations of effects of mortgage-interest tax deduction on US house prices per Poterba—employs *ex post* calculations. Here there is, at least in principle, a single ‘correct’ answer—even if in practice the data with which to determine it may not be available. However our intention was to understand the factors that influenced the decisions of housing-market actors about whether to buy or rent by looking at the information they had *at the time of decision*—when by definition future outcomes (e.g. house prices movements) could not be known. We therefore calculated historic user costs not on the basis of actual price movements but on the basis of expectations at the time.

We assume that the economic actors are rational and that their decisions will be based on (if not necessarily entirely determined by) user costs. Current user costs incorporate expectations about house prices, interest rates and other variables, and therefore implicitly include an element of forecasting. Economic actors cannot know with certainty what house

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<sup>10</sup> In addition the landlord receives the capital gain (or loss) on the property, which is deducted in the tenants’ rent calculation.

prices, interest rates or the tax code will be like in ten years' time (or even next year); they have to make assumptions taking into account the current situation, economic trends, and their assessment of political and even cultural factors that may influence markets.

What values should be used for expected house prices and interest rates? There is a large body of literature dealing with the selection and use of forecasting techniques. Armstrong (2001) provides a useful overview including general principles. He recommends that simple methods be used unless empirical evidence calls for a more complex approach, and suggests that forecasters, using their expert knowledge, should adjust for events expected in the future. Forecasts (assumptions) may also vary according to the time horizon employed: in general for very short time horizons we can assume that conditions will continue as they are now, while for longer time horizons we might expect values to follow a trend, or to revert to a long-term mean.

### 7.3 ASSUMPTIONS

Our historic user-cost calculations are based on published data, but for current user-cost calculations we must make assumptions about how some of the variables will develop over time. We have chosen to look at three time horizons: one, three and five years. Given that housing-market cycles can last a decade or more we would ideally have preferred to use longer time periods, but data availability would have made the calculations impossible.

Table 7.1 below lists the variables that go into our user-cost calculations for owner-occupied property. Our baseline, following Armstrong's principles, is to keep the assumptions simple, with changes expected only for mortgage interest rates and house prices. Both of these variables are expected to revert to the mean of the last three and five years under the three- and five-year time horizons respectively. However we have asked country experts to use their best judgment about likely future policy changes, so the assumptions used may differ from country to country.

**Table 7.1: Baseline expectations for one-, three- and five-year time horizons (changes highlighted)**

<i>Variable</i>	<i>Time horizon</i>		
	<i>One year</i>	<i>Three years</i>	<i>Five years</i>
<i>Loan-to-value ratio</i>	As now	As now	As now
<i>Average mortgage interest rate</i>	As now	Mean of last 3 years	Mean of last 5 years
<i>Return on similarly risky alternative investment</i>	As now	As now	As now
<i>Basic rate tax on alternative investment</i>	As now	As now	As now
<i>Maintenance</i>	As now	As now	As now
<i>Depreciation</i>	As now	As now	As now
<i>Change in house prices</i>	As last year	3-year mean	5-year mean

Prospective FTBs implicitly must choose between investing in the down payment on a home, or investing the funds in another way. The interest foregone on this alternative investment is therefore one element of user cost. For these calculations we used data on returns from government bonds from each country (see sources for each country table). These are less



risky than residential property investment, so we added a risk premium of 3% to the bond yields to account for this difference, per Diamond (1980).<sup>11</sup>

## 7.4 OUTPUTS

The end result, for each country, is a set of calculated user costs for first-time buyers (from Equation 1, modified as appropriate for each country), and rents for young single tenants taken from local rent statistics. Separately we also provide information about landlords' returns from IPD data, and about returns on alternative categories of investment. These findings are presented in Chapter 8.

Annual user costs are calculated from 1988 (England), 1990 (Germany) and 1996 (The Netherlands) and 1980 (Denmark). Changes in capital value are one of the main determinants of user cost for owner occupiers, but future house price changes cannot be known in advance. We therefore produced three scenarios, in which expected future house-price changes are based on housing-market performance in the preceding one, three and five years. Thus the calculations use *ex post* data for house prices, loan-to-value ratios, mortgage interest rates and taxes, but the house-price data also feed into *ex ante* forecasts of house price movements. *We have not made ex post calculations of actual user cost as our intention was to look at decision factors—which by definition are ex ante.*

This approach allows us to make comparisons within each country over time and across tenures, and to look at broad trends across countries. We do not use the tables as a basis for detailed cross-country comparisons.

## 7.5 THE QUESTION

In this report we employ user-cost analysis to shed light on the following question:

*Question: What are the relative consumer user costs of renting and owning in each of the four case-study countries, and what does that imply for household tenure choice?*

Consumers, who are assumed to be rational utility maximisers, will select the tenure that provides them with the lowest cost (or the highest gain), all else being equal. We focus on those entering the housing market: young households choosing between renting and purchasing a home for the first time. (Of course, this is a simplification since in real life choices are rarely binary--households could also share with another family, not form at all, etc.)

The calculations required (columns A and B in Table 7.2):

- User cost of owner-occupation
- User cost of renting – ie the rent paid out of taxed income.

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<sup>11</sup> Diamond (1980) applies a 3% risk premium for similar calculations in the US context. He notes that 'the results...are quite insensitive to the specific risk premium assumed to apply to the...equity investment, as long as it is an assumed constant over time' (p.296).

The results from this analysis can then be used as an input into a qualitative assessment of when/whether landlords might be prepared to add to their portfolios either from the existing stock or in terms of new investment.

## **7.8 INFLUENCE OF POLICY CHANGES**

User costs are not fixed but vary frequently—in principle even day by day—in response to changes in the relevant variables. Clearly these include many economic variables that fluctuate constantly, such as interest rates and house prices—although these may be fixed for the long term or even permanently for individual purchasers and tenants, any changes affect aggregate calculations. But apart from these continuously moving variables, there are policy-related variables which can exhibit sharp discontinuities, and these discontinuities should in principle be observable in user-cost calculations. The list of variables that could be affected by policy changes includes

- Taxes
- Interest rates
- Cost of repairs (e.g. if standards are changed/imposed)
- Proportion of price borrowed (e.g. if LTV limits are changed/imposed).
- Rent regulations and other housing policy measures.
- Rules around mortgage issuance and eligibility

For each country we have produced a qualitative timeline which identifies important changes in policy or regulation affecting the PRS or other tenures. These could produce inflection points or discontinuities that might feed through into (assumed) periods of relative advantage for one tenure or another. However it remains to be seen whether these policy changes are observable in user-cost calculations because of data problems, time lags, the specifics of regulations (e.g. applied to new purchases only), etc.

## Chapter 8: User costs in England, the Netherlands, Germany and Denmark

This chapter applies the user-cost concept to the PRS in England, the Netherlands, Germany and Denmark. We look at user costs for three groups: first-time buyers (FTBs), tenants and landlords. We then look at the results for each country to ask whether user cost analysis helps to identify and quantify important drivers of behaviour - and to clarify its strengths and limitations.

Our starting point is this: prospective tenants will choose between private renting and owner occupation in part because of the relative costs to the individual of the two tenures, while landlords will invest in private renting if the expected risk-adjusted return is equal to or higher than what is available on alternative investments. Neither of these measures will fully relate to the formal definition of user cost set out in chapter 7. However the main drivers of behaviour are best reflected in these formulae. Thus analysts can gain understanding of behaviour by examining the evidence on how user costs change over time and asking whether there is a relationship between these changes and shifts in tenure mix.

### 8.1 ENGLAND

We start with England. We look first at user cost for first-time buyers, then for tenants.

#### First-time buyers

The user-cost equation for first-time buyers in England is adapted from Lunde's user-cost equation for owner occupation (presented on page 77 above). We have modified the designations of some of the variables to make them more intuitive. The equation is:

$$UC_t = P_t (LTV \cdot I_{mortgage} + [1-LTV] \cdot R_{altinv} \cdot [1 - T_{altinv}] + M_t + D_t - \Delta P_t)$$

where

$UC_t$  is user cost at time  $t$

$P_t$  is the house price

$LTV$  is the loan-to-value ratio

$I_{mortgage}$  is the interest rate on the loan

$R_{altinv}$  is the rate of return on an alternative investment with the same risk

$T_{altinv}$  is the rate of tax on returns from an alternative investment with the same risk

$M_t$  is maintenance, administrative and operational expenditure

$D_t$  is the rate of depreciation

$\Delta P_t$  is the rate of price increase for the property if quality is unchanged.

Lunde's equations (pp 77 et seq) contain elements for land and property tax, but these are not included in the English formula. There is no annual tax on ownership of land or property in the UK. Council tax is levied by local authorities on residents, with amounts due based on dwelling values. It is paid by all residents whether tenants or home owners, so is not included as a specific cost of home ownership.

Table 8.1 provides calculations for English FTBs for the 25-year period 1988-2013. There are three scenarios, reflecting possible home buyer attitudes to expected capital gains:

- In Scenario A their expectations of capital gains are based on price changes in the single preceding year
- Scenario B: expected capital gains = 3-year average price change
- Scenario C: expected capital gains = 5-year average price change

The data used are set out in the table except for  $M_t$  (maintenance as a percentage of house value), which was set at 2% per annum, and  $D_t$  (depreciation), which was set at 1% per annum in Miles (Miles, 1994).

Looking at the underlying data, it is clear that this covers a period of strong cyclical change in the housing market. Average house prices for first-time buyers rose strongly in 1988 but peaked in 1990 and then did not regain their 1990 level for seven years. There was another strong surge in house prices in the early 2000s, and average prices for FTBs doubled between 2000 and 2005. They reached a peak in 2007 and then fell; by 2013 when our data series ends they had not yet reached former peak levels.

Other variables also fluctuated over large ranges. Median loan-to-value ratios for first-time buyers were consistently above 90% in the 1980s and 90s, but fell to a post-crash low of 75% in 2009 when mortgage credit was massively constrained. Similarly, mortgage interest rates in England (as elsewhere) fell over this period, from over 14 per cent in 1989 and 1990 to under five per cent since 2009. Rates of return on alternative investments followed a similar pattern, peaking in 1990 at over 11 per cent as compared to under two per cent in 2012.

But the most volatile set of figures is the penultimate column: changes in house prices. One-year changes have ranged from growth of 22 per cent (in 1989 and 2003) to a decline of 12 per cent in 2009. The user-cost equation captures the costs of running a home (maintenance and mortgage payments) as well as capital gains, which can be thought of as *negative costs*. Therefore a user-cost figure that is negative indicates that the user is *gaining* overall – that is, that (expected) capital gains exceed housing expenditure. Obviously, this cannot be a permanent position for the housing market.

**Table 8.1: User costs for first-time buyers in England and estimated rents, 1988 - 2013**

Year	Housing expenditure	User cost including expected capital gains			Average house price for FTB	LTV	Mortgage rate	Down payment	Return on foregone investment adjusted for risk	Tax on return on foregone investment	Change in FTB house price	Rent on 2-bed flat
		Scenario A	Scenario B	Scenario C								
1988	£5,559	-£1,888	-£50	£1,090	95%	12.50%	5%	12.79%	25%	20%		
1989	£7,582	-£2,313	-£1,095	£760	95%	14.25%	5%	13.27%	25%	22%		
1990	£7,681	£7,805	£1,339	£1,575	95%	14.25%	5%	14.72%	25%	1%		
1991	£6,269	£7,021	£3,211	£1,165	95%	11.25%	5%	13.13%	25%	0%		
1992	£5,367	£8,254	£6,590	£2,435	95%	9.90%	5%	12.12%	25%	-5%		
1993	£4,324	£6,532	£6,211	£3,619	94%	7.95%	6%	10.56%	25%	-3%		
1994	£4,438	£4,790	£6,222	£5,653	95%	8.10%	5%	11.14%	25%	1%		
1995	£4,459	£5,568	£5,673	£5,870	95%	8.25%	5%	11.20%	25%	-1%		
1996	£4,158	£2,979	£4,266	£5,249	95%	7.19%	5%	10.81%	24%	4%		
1997	£4,668	£2,604	£3,961	£4,793	95%	7.78%	5%	10.05%	23%	6%		
1998	£5,223	£3,459	£3,500	£4,532	93%	8.62%	7%	8.55%	23%	5%		
1999	£4,581	£1,709	£2,300	£3,253	90%	6.92%	10%	8.10%	23%	7%		
2000	£5,388	£256	£1,978	£2,588	90%	7.55%	10%	8.33%	22%	10%		
2001	£5,345	£1,586	£1,117	£1,869	90%	6.81%	10%	7.93%	22%	7%		
2002	£5,457	-£6,455	-£2,140	-£393	90%	5.66%	10%	7.89%	22%	17%		
2003	£6,451	-£12,270	-£6,401	-£3,801	89%	5.47%	11%	7.53%	22%	22%		
2004	£8,287	-£12,428	-£11,800	-£6,872	87%	6.15%	13%	7.88%	22%	20%		
2005	£9,705	-£188	-£9,477	-£7,048	90%	6.53%	10%	7.41%	22%	10%	£5,872	
2006	£10,616	-£48	-£4,922	-£8,303	90%	6.51%	10%	7.50%	22%	9%	£6,035	
2007	£12,909	£622	£979	-£5,692	90%	7.44%	10%	8.01%	22%	10%	£6,003	
2008	£11,111	£21,749	£7,334	£1,541	86%	6.90%	14%	7.59%	20%	-6%	£6,064	

2009	£6,183	£24,229	£12,398	£6,370	£122,468	75%	4.05%	25%	6.65%	20%	-12%	£6,265
2010	£6,313	£6,807	£15,864	£8,305	£124,674	77%	3.96%	23%	6.61%	20%	2%	£6,445
2011	£6,473	£10,578	£13,816	£10,834	£122,977	80%	4.08%	20%	6.11%	20%	-1%	£6,600
2012	£6,533	£10,208	£9,025	£13,314	£121,451	80%	4.22%	20%	4.90%	20%	-1%	£6,900
2013	£7,130	£1,025	£7,825	£11,260	£129,441	80%	4.37%	20%	5.45%	20%	7%	£6,900

**Sources:**

Average house price for FTB: Halifax all UK

LTV ratio: median LTV for first-time buyers from CML Table ML2: 'First time buyers, new mortgages and affordability, UK'

Mortgage rate: CML Table IR3 Average quoted lending interest rates, banks and building societies from 1995; before from [http://www.thehanley.co.uk/standard-variable-interest-rate-history\\_297.html](http://www.thehanley.co.uk/standard-variable-interest-rate-history_297.html)

Rate of return on alternative investment: Annual average yield from British Government Securities, 10-year nominal par yield IUAAMNPY + 3% risk premium

Tax on alternative investment: basic rate tax from Institute for Fiscal Studies historic income tax rates

Rents: Median private rents for two-bedroom property in England, as of September each year. 2011-2013 data from Valuation Office Agency (see Table 5.2) ; pre-2011 calculated using ONS Experimental Private Rent Index

We can see that in Scenario 1 (where expected capital gains reflect the previous year's experience), first-time buyers had negative user costs in the late 1980s, then from 2002 to 2005, reflecting the strong house-price growth in those periods. Even when house-price growth was averaged over five years, user cost was negative for long periods although the troughs were not as low. This can be seen in Figure 8.1, which graphs user costs under Scenarios A, B and C. Conversely in 2009 the Scenario A user cost was very high, reflecting expected capital *losses* due to recent declines in house prices.

**Figure 8.1: Three scenarios for user costs for first-time buyers in England, 1988 – 2013**

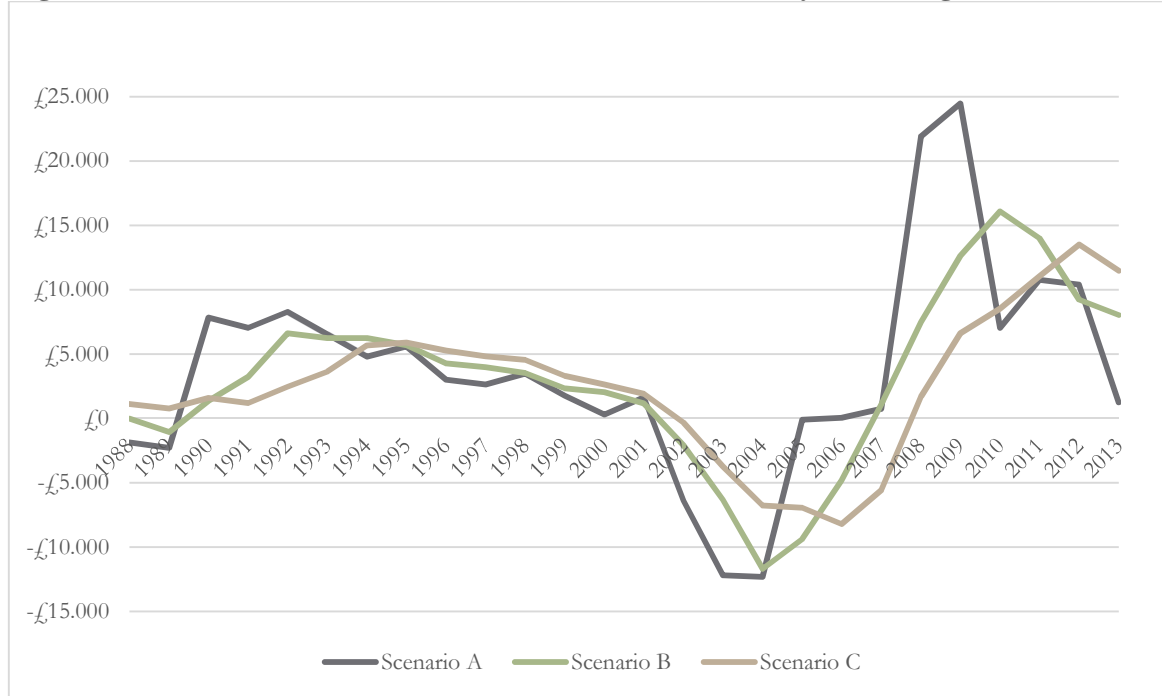
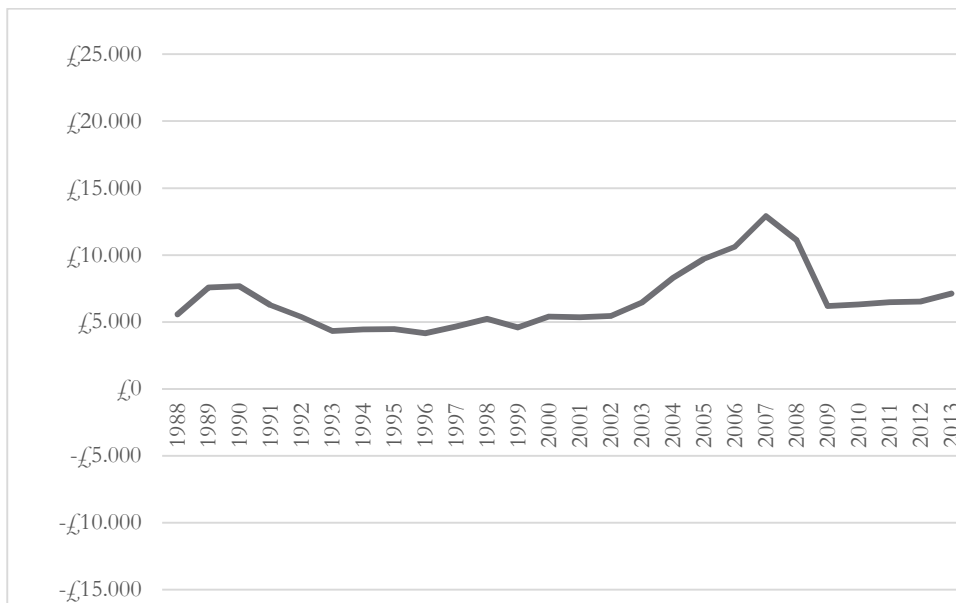


Figure 8.2, on the same scale, shows user costs excluding expected capital gains and foregone income from alternative investment—that is, only actual housing expenditure. This includes mortgage payments, maintenance and property taxes. Here there are no negative costs (gains). There is still a fair amount of variation, with expenditure ranging from £4153 per annum in 1996 to almost £13,000 in 2007; this stems again from movements in house prices and the consequent effect on mortgage payments as well as changes in the mortgage rates themselves linked to changes in inflation. However the variation is very small compared to the user cost *including* expected capital gains.

**Figure 8.2: Housing expenditure for first-time buyers in England, 1988 -2013**



### **Tenants**

Comparing the user cost of owner-occupation for first-time buyers with the user cost of PRS accommodation for tenants (the rent) should cast light on households' tenure choices. Unfortunately the official data on private sector rents in England are not good. The best official source is the Valuation Office, which compiles data on private-sector rents for the purposes of administering housing benefit, but its published data start only in 2011. They do however produce figures that are broken down by size of dwelling, which would allow us to compare rents for a particular size of property (say, two-bed flats) with the FTB data for those years.

Table 8.2 shows private rents in England and London for two-bed properties (median and average lower-quartile). They represent rents on existing tenancies not new lets, although decisions are based on new let rents. In England the great majority of private rented tenancies are for fixed six- or twelve-month terms and the landlord is not obliged to offer renewal when the tenancy ends. There is no control of starting rents or of rent increases after the initial tenancy period.



**Table 8.2: Annual private-sector rents, England, 2011-2015**

12-month rolling average private rents for 2-bed property  
(data quarterly to 2012, then semi-annual)

End date	England		London	
	Lower quartile	Median	Lower quartile	Median
June 2011	£5,700	£6,600	£11,400	£14,304
September 2011	£5,700	£6,600	£11,400	£14,340
December 2011	£5,700	£6,600	£11,400	£14,400
March 2012	£5,700	£6,780	£11,700	£14,400
June 2012	£5,700	£6,840	£12,000	£14,760
September 2012	£5,700	£6,900	£12,000	£15,000
December 2012	£5,700	£6,900	£12,300	£15,600
March 2013	£5,700	£6,900	£12,900	£16,116
September 2013	£5,700	£6,900	£13,200	£16,644
March 2014	£5,700	£6,900	£13,200	£16,500
September 2014	£5,820	£6,960	£13,800	£16,644
March 2015	£5,940	£7,140	£14,400	£16,800

Source: Valuation Office Agency Private Rental Statistics

**Figure 8.3: Annual median and lower-quartile rents, England and London, 2011-2015**

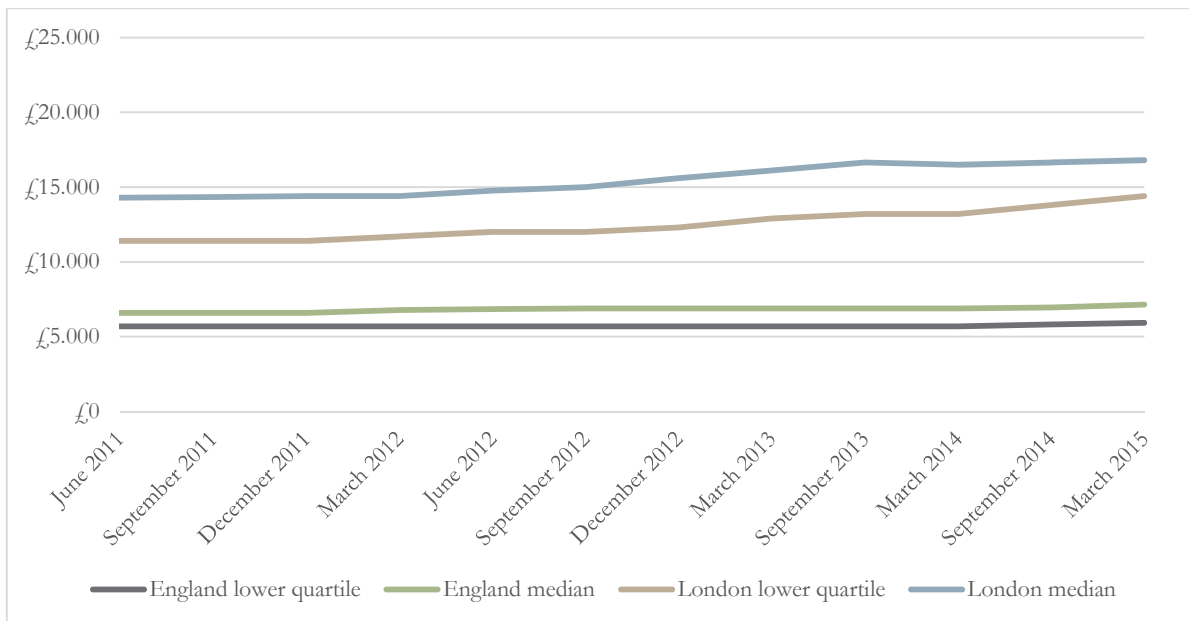
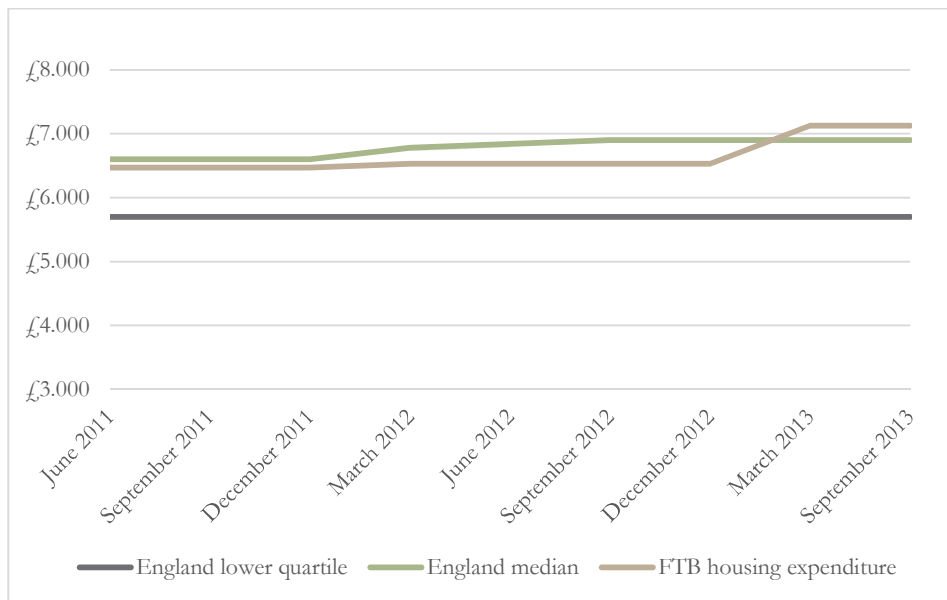


Figure 8.3 gives the evolution of annual median and lower-quartile rents for England and London for the four years from mid-2011 to mid-2015. These show that rents have risen steadily and fairly smoothly over the period. It is also possible to get rental data for two-bedroom flats. These are often preferred as a benchmark for comparison with first-time buyer costs, as the two-bedroom flat is considered the standard rental unit and represents plausible alternative accommodation for such households.

Figure 8.4 compares median and lower-quartile rents for such flats (all England) with housing expenditure for owner occupation. It shows that on this broad measure the

current costs of home ownership were slightly cheaper than renting over most of the period, although the absolute difference was not large. It should be noted however that data availability means that the series is very short—the figure covers only four years vs 25 years in Figure 8.2.

**Figure 8.4 Comparison of FTB housing expenditure and private rents for two-bed flats, 2011 - 2013**



Overall therefore the figures suggest that the factors lying behind the changes in relative costs are more related to house prices, inflation and interest rates than to changes in the tax framework. The UK has a relatively volatile economy which is reflecting in the variability of user costs over time. The measures also suggest that owner-occupation has generally been a relatively good buy as compared to private renting - especially if the data were better able to take account of size and quality of accommodation.

What is also obvious is that the affordability crisis of the early 2000s is about house price increases and associated mortgage costs - which were, on broader based analysis, high enough to exclude many potential first time buyers from becoming owner-occupiers and to generate lower proportions of owner-occupiers overall. The economic environment after the financial crisis actually reduced first-time buyer outgoings - but other uncertainties and particularly credit constraints meant many who could afford on paper owner-occupation were either excluded or chose not to purchase (Whitehead and Williams, 2011; Whitehead, Williams et al, 2012).

## 8.2 GERMANY

We now look at user costs in Germany, taking again first-time buyers and tenants.

### First-time buyers

The user-cost equation for first-time buyers in Germany is similar to that used for England, with the addition of a significant element for the subsidy for first-time home buyers (*Eigenheimzulage*), which was available from 1991 to 2006. This element,  $S_t$ , is the final variable in the equation below. Like expected capital gains it *reduces* user cost.

$$UC_t = P_t (LTV \cdot I_{mortgage} + [1-LTV] \cdot R_{altinv} \cdot [1 - T_{altinv}] + M_t + D_t - \Delta P_t - S_t)$$

$S_t$  is the subsidy for first-time home buyers

Land tax is paid by the user and is tenure neutral. It is therefore excluded. Germany has no property tax.

Table 8.3 provides calculations for German FTBs for the 22-year period 1991-2013. There are three scenarios, reflecting possible home buyer attitudes to expected capital gains:

- In Scenario A their expectations of capital gains are based on price changes in the single preceding year
- Scenario B: expected capital gains = 3-year average price change
- Scenario C: expected capital gains = 5-year average price change

The data used are shown in the table except for  $M_t$  (maintenance as a percentage of house value), which was set at 2% per annum, and  $D_t$  (depreciation), which was set at 1%. The same assumptions were used for England.

Figure 8.5 shows that user costs for first-time buyers were positive—that is, that overall there was a cost to buyers—from 1990 to 2012, when they turned negative.

**Figure 8.5 Three scenarios for user costs for first-time buyers in Germany, 1991 - 2013**

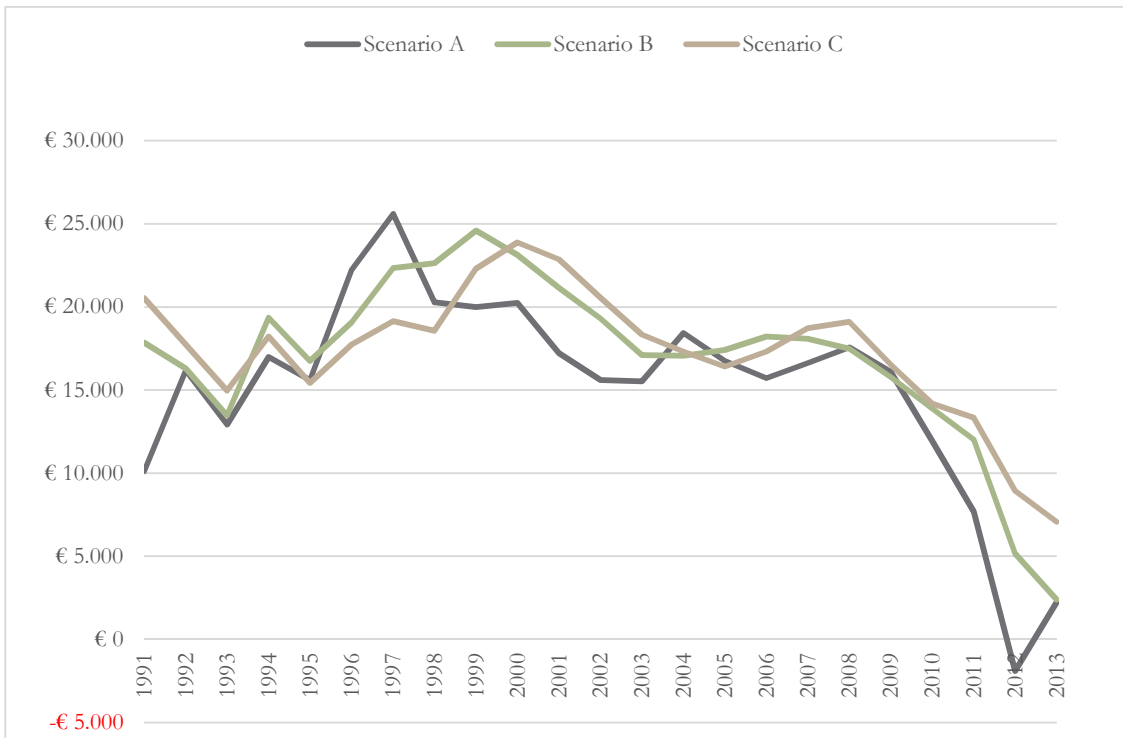


Table 8.3: User costs for first-time buyers and rents for tenants, Germany, 1991 - 2013

Year	Housing expenditure	User cost including expected capital gains			Average house price for FTB	LTV	Mortgage rate	Down payment %	Return on foregone investment adjusted for risk	Tax on foregone investment	Change in FTB house price	Annual subsidy	Rent
		Scenario A	Scenario B	Scenario C									
1990	€ 15,418	€ 16,838	€ 19,916	£21,955	€ 202,486	70%	9.89%	30%	12.2%	22%	3%	€ 2,649	€ 8,148
1991	€ 15,413	€ 9,630	€ 17,374	£20,062	€ 208,234	70%	9.45%	30%	11.9%	22%	4%	€ 2,526	€ 8,844
1992	€ 14,858	€ 15,701	€ 15,806	£17,246	€ 215,644	70%	8.55%	30%	10.9%	23%	4%	€ 2,361	€ 9,612
1993	€ 13,814	€ 12,416	€ 12,960	£14,455	€ 222,478	70%	7.34%	30%	9.2%	23%	4%	€ 2,066	€ 10,164
1994	€ 16,266	€ 16,469	€ 18,835	£17,700	€ 228,674	70%	8.81%	30%	10.7%	23%	3%	€ 2,409	€ 10,164
1995	€ 14,348	€ 15,057	€ 16,218	£14,895	€ 226,957	70%	7.46%	30%	8.7%	22%	3%	€ 2,043	€ 9,684
1996	€ 12,880	€ 21,691	€ 18,530	£17,201	€ 220,594	70%	7.09%	30%	8.2%	21%	-1%	€ 2,480	€ 9,096
1997	€ 12,113	€ 25,081	€ 21,820	£18,626	€ 217,223	70%	6.66%	30%	8.4%	22%	-2%	€ 2,358	€ 8,760
1998	€ 10,335	€ 19,781	€ 22,124	£18,066	€ 215,993	70%	5.29%	30%	7.7%	23%	-2%	€ 1,983	€ 8,484
1999	€ 11,623	€ 19,496	€ 24,085	£21,796	€ 214,632	70%	6.40%	30%	8.8%	23%	1%	€ 2,285	€ 8,436
2000	€ 11,762	€ 19,737	€ 22,630	£23,376	€ 216,018	70%	6.44%	30%	9.0%	21%	1%	€ 2,296	€ 8,520
2001	€ 11,209	€ 16,705	€ 20,635	£22,348	€ 218,495	70%	5.87%	30%	9.5%	21%	1%	€ 2,139	€ 8,664
2002	€ 10,850	€ 15,080	€ 18,783	£20,037	€ 219,897	70%	5.52%	30%	8.9%	21%	0%	€ 2,044	€ 8,748
2003	€ 10,254	€ 14,997	€ 16,568	£17,807	€ 217,888	70%	5.14%	30%	7.3%	20%	-1%	€ 1,944	€ 8,772
2004	€ 10,101	€ 17,908	€ 16,544	£16,792	€ 216,810	70%	4.63%	30%	6.9%	21%	-1%	€ 1,262	€ 8,784
2005	€ 9,618	€ 16,229	€ 16,895	£15,896	€ 218,994	70%	4.19%	30%	6.7%	20%	-1%	€ 1,185	€ 8,796
2006	€ 11,573	€ 15,199	€ 17,698	£16,798	€ 221,711	70%	4.60%	30%	7.3%	21%	0%	€ 0	€ 8,892
2007	€ 12,371	€ 16,106	€ 17,561	£18,199	€ 224,080	70%	5.03%	30%	8.5%	22%	1%	€ 0	€ 8,988
2008	€ 12,173	€ 17,049	€ 16,966	£18,588	€ 226,216	70%	4.83%	30%	9.9%	23%	1%	€ 0	€ 9,240
2009	€ 11,575	€ 15,547	€ 15,243	£15,995	€ 231,352	70%	4.29%	30%	7.8%	22%	1%	€ 0	€ 9,444
2010	€ 11,076	€ 11,394	€ 13,337	£13,621	€ 241,309	70%	3.70%	30%	6.8%	21%	3%	€ 0	€ 9,732
2011	€ 11,603	€ 7,125	€ 11,456	£12,763	€ 259,118	70%	3.54%	30%	7.6%	22%	4%	€ 0	€ 10,236
2012	€ 10,831	-€ 2,512	€ 4,559	£8,332	€ 274,480	70%	2.78%	30%	6.3%	23%	3%	€ 0	€ 10,728

2013	€ 11,857	€ 1,586	£1,744	£6,420	€ 296,800	70%	2.85%	30%	6.5%	23%	6%	€ 0	€ 11,244
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Sources:

Mortgage rate: Deutsche Bundesbank, ECB. 1990-2002 Bundesbank 10-year fixed rate, end year. 2003-2013 ECB, 5-10 years, end year.
Average house price for FTB: BulwienGesa Immobilienpreisindex average price for new apartment, 100m <sup>2</sup>
Rate of return on alternative investment: Annual average yield from corporate bonds. + 3% risk premium, Bloomberg
Tax on alternative investment = average tax rate, Ministry of Finance
Cost of renting: rent for new apartment, 100 m <sup>2</sup> per BulwienGesa Immobilienpreisindex
LTV - assumed
Subsidy: Assumptions: couple with two children, house used over a period of 40 years
Eigenheimzulage annualised

## Tenants

Figure 8.6 compares the housing expenditure of first-time buyers with rents for new apartments of 100m<sup>2</sup>. It shows that owner-occupation required higher outlays than renting. The difference between the two tenures was very large in the early 1990s, with owning costing almost twice as much as renting in 1991, but the difference between the tenures has narrowed in the last 20 years to the point where in 2013 for the first time housing expenditure for owner-occupiers was less than rent. As in England, housing expenditures for owner occupation were much more volatile than rents.

**Figure 8.6: Comparison of owner-occupation housing expenditure and rents**



First-time buyer user costs reflect much lower capital gains than in England - and indeed in some years capital losses. As a result costs of owner-occupation are always significantly positive until the late 2000s when lower interest rates are combined with increasing house prices. Direct expenditures reflect changes in macro-economic variables in the owner-occupied sector, rather than tax changes, while rents follow an upward path from the late 1990s. As a result by 2012 for the first time expenditures become very similar across the two tenures. It is thus not surprising to observe increasing rates of owner-occupation with an upward trajectory reflecting expectations of capital gains and falling user costs.

### 8.3 NETHERLANDS

We now turn to the Netherlands. The analysis here is slightly different than those carried out for England and Germany. Those employed house-price data for the smaller homes that first-time buyers tend to purchase. However the Dutch house-price data do not allow us to isolate smaller homes, so we discuss user costs for *all* home buyers.

## Home buyers

The user-cost equation for home buyers in the Netherlands employs *after-tax* figures for both the mortgage interest rate and the interest on foregone investments. Those elements are highlighted in the equation below. There is no separate term for the tax on returns from alternative investments. As in England and Germany, land/property tax is in principle tenure-neutral so is not included in the user cost for owner-occupation.

$$UC_t = P_t (LTV \cdot I_{mortgage} + [1-LTV] \cdot R_{altinv} + M_t + D_t - \Delta P_t)$$

Table 8.4 provides calculations for Dutch home buyers for the 17-year period 1996-2013. The three scenarios again reflect possible home buyer attitudes to expected capital gains:

- In Scenario A their expectations of capital gains are based on price changes in the single preceding year
- Scenario B: expected capital gains = 3-year average price change
- Scenario C: expected capital gains = 5-year average price change

The data used are shown in the table except for  $M_t$  (maintenance as a percentage of house value), which was set at 1% per annum, and  $D_t$  (depreciation), which was set at 0.85%. Both figures are based on the Dutch literature; they are somewhat lower than the assumptions used for the English and German cases.



**Table 8.4 User costs for home buyers in the Netherlands, 1996-2013**

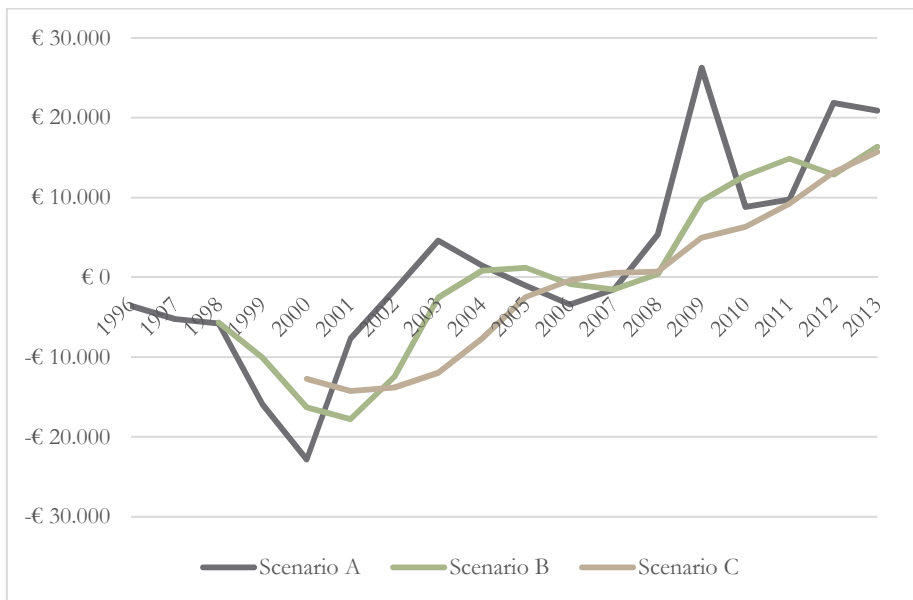
Year	Housing expenditure	User cost including expected capital gains			Average house price--all existing homes	LTV	After-tax mortgage interest rate	Down payment %	After-tax rate of return on foregone investment, adjusted for risk	Maintenance as % of house value	Change in house price	Rents on new homes
		Scenario A	Scenario B	Scenario C								
1996	€ 3,273	-€ 3,774			€102,607	73%	3.00%	27%	6.93%	1%	9.4%	€ 4,650
1997	€ 3,471	-€ 5,442			€113,163	74%	2.79%	26%	6.41%	1%	10.3%	€ 4,812
1998	€ 3,705	-€ 6,028	-€ 5,873		€124,540	74%	2.67%	26%	6.01%	1%	10.1%	€ 4,932
1999	€ 4,091	-€ 16,195	-€ 10,327		€144,778	74%	2.47%	26%	5.34%	1%	16.3%	€ 5,052
2000	€ 5,411	-€ 23,108	-€ 16,587	-€ 13,022	€172,050	76%	2.82%	24%	5.34%	1%	18.8%	€ 5,346
2001	€ 6,031	-€ 7,958	-€ 18,059	-€ 14,523	€188,397	78%	2.82%	22%	5.88%	1%	9.5%	€ 5,640
2002	€ 5,984	-€ 1,931	-€ 12,773	-€ 14,129	€199,752	78%	2.56%	22%	5.57%	1%	6.0%	€ 5,860
2003	€ 5,499	€ 4,280	-€ 2,851	-€ 12,290	€204,829	78%	2.16%	22%	5.52%	1%	2.5%	€ 6,080
2004	€ 5,560	€ 1,178	€ 568	-€ 7,965	€212,723	81%	1.99%	19%	4.98%	1%	3.9%	€ 6,300
2005	€ 5,563	-€ 1,307	€ 913	-€ 2,711	€222,706	83%	1.80%	17%	4.97%	1%	4.7%	€ 6,660
2006	€ 6,573	-€ 3,655	-€ 1,100	-€ 599	€235,843	85%	2.10%	15%	4.46%	1%	5.9%	€ 7,020
2007	€ 7,637	-€ 1,747	-€ 1,753	€ 330	€248,325	87%	2.39%	13%	4.75%	1%	5.3%	€ 6,978
2008	€ 8,364	€ 5,182	€ 185	€ 534	€254,918	89%	2.56%	11%	5.10%	1%	2.7%	€ 6,936
2009	€ 7,385	€ 26,096	€ 9,404	€ 4,806	€238,259	90%	2.33%	10%	5.06%	1%	-6.5%	€ 7,212
2010	€ 7,228	€ 8,690	€ 12,639	€ 6,209	€239,530	93%	2.17%	7%	4.68%	1%	0.5%	€ 7,488
2011	€ 7,172	€ 9,588	€ 14,744	€ 9,078	€240,059	91%	2.18%	9%	4.19%	1%	0.2%	€ 7,512
2012	€ 6,541	€ 21,743	€ 12,740	€ 13,040	€226,661	92%	2.05%	8%	4.19%	1%	-5.6%	
2013	€ 5,579	€ 20,734	€ 16,195	€ 15,561	€213,353	89%	1.81%	11%	3.45%	1%	-5.9%	

Sources:

Average house price	<a href="http://statline.cbs.nl/StatWeb/publication/?DM=SLNL&amp;PA=81884ned&amp;D1=0-2,6&amp;D2=101,118,135,152,169,186,203,220,237,254,271,288,305,322-325, &amp;HDR=T&amp;STB=G1&amp;VW=I">http://statline.cbs.nl/StatWeb/publication/?DM=SLNL&amp;PA=81884ned&amp;D1=0-2,6&amp;D2=101,118,135,152,169,186,203,220,237,254,271,288,305,322-325, &amp;HDR=T&amp;STB=G1&amp;VW=I</a>
LTV:	Blijie, 2010, Woonuitgaven huurders en kopers, Min BZK, p.44,
	Boumeester and Boelhouwer, 2014, Monitor koopwoningmarkt 1e kwartaal 2014, Delft, OTB, p.1
	and experts' extrapolation
Mortgage rate to 2003:	<a href="http://statline.cbs.nl/StatWeb/publication/?DM=SLNL&amp;PA=37276mfo&amp;D1=a&amp;D2=0,13,26,39,52,65,78,91,104,117,119-130&amp;HDR=T&amp;STB=G1&amp;VW=I">http://statline.cbs.nl/StatWeb/publication/?DM=SLNL&amp;PA=37276mfo&amp;D1=a&amp;D2=0,13,26,39,52,65,78,91,104,117,119-130&amp;HDR=T&amp;STB=G1&amp;VW=I</a>
2004 and after:	<a href="http://www.statistics.dnb.nl/financieele-instellingen/banken/binnenlandse-bankbedrijf-monetair/index.jsp">http://www.statistics.dnb.nl/financieele-instellingen/banken/binnenlandse-bankbedrijf-monetair/index.jsp</a>
Rate of return on foregone investment	long-term interest rates, % per annum from <a href="http://stats.oecd.org/index.aspx?querytype=view&amp;queryname=86#">http://stats.oecd.org/index.aspx?querytype=view&amp;queryname=86#</a> + 3% risk premium
Depreciation	Conijn, J.B.S., 1995, Enkele financieel-economische grondslagen van de volkshuisvesting, Delft, Delftse Universitaire Pers

Figure 8.7 shows that user costs for home buyers were negative—that is, that overall home buyers *gained* from house purchase—from 1996. They turned positive (indicating a cost to buyers) in 2002 under Scenario A, and somewhat later under Scenarios B and C. The cost of home ownership under all three scenarios has been escalating since about 2007.

**Figure 8.7: Three scenarios for user costs for home buyers in the Netherlands, 1996-2013**



### Tenants

Figure 8.8 shows average rents on all new homes and housing expenditure of home buyers—that is, removing expected capital appreciation and investment interest foregone—from 1996. As in England and Germany, rents (which in the Netherlands are generally controlled) have risen fairly smoothly since 1996. Housing expenditures of new buyers were much more volatile, more than doubling in the ten years after 1996, but since 2008 have fallen significantly. When expected capital appreciation and foregone interest are removed, housing expenditures track rents fairly closely over the whole period. However it should be emphasised that these figures are indicative only, as the two sets of dwellings to which they refer (all new rental homes and all existing homes for sale) are not strictly comparable.

**Figure 8.8 Annual housing expenditure for home buyers and rents on new homes in the Netherlands, 1996-2011**



The figures for the Netherlands show fairly consistent rises in rental costs over the whole estimation period from 1996 - 2011. Owner-occupied expenditures also rise - indeed overall they rise considerably more - but not so consistently. Importantly, owner-occupied expenditures are sometimes lower than rental, sometimes higher and since 2010 fairly similar. On the broader based user cost of owner-occupation measure these costs are negative for almost all of the decade from mid 1990s to the mid- 2000s (when owner-occupation rises but not rapidly). From the turn of the century they rise rapidly first as house prices increase but after the financial crisis more as a result of falling capital gains. There have been far more significantly changes in housing policies in the Netherlands than in most other European countries especially since the global financial crisis. These clearly affect user costs for both owner-occupiers and tenants - but it would need far more detailed analysis, and a longer time period, to estimate the scale of policy impacts.

#### 8.4 DENMARK

The user cost formula for owner-occupiers in Denmark is

$$UC_t = P_t [LTV \cdot I_{mortgage} \cdot (1-Ded) + (1-LTV) \cdot R_{altinv} \cdot (1-T_{altinv}) + (T_{landvalue} + D_t - \Delta P_t)] + T_{property} + M_t$$

The variables are as for England, with the following additions:

Ded is the rate at which mortgage interest payments can be deducted from taxable income

$T_{landvalue}$  is land value tax

$T_{property}$  is property value tax

Maintenance and operational expenditures ( $M_t$ ) are based on empirically established expenditure in 1999 (Lunde and Hvidt 1999), uprated for inflation. They are not a function of house price as in the calculations for the other three countries.

It should be noted that these user-cost calculations are different from the housing-market equations that appear in the widely used ADAM macroeconomic model of the Danish economy (Statistics Denmark 2012). In this paper we are trying to capture the costs of owner occupation in Year 1, while the purpose of the ADAM model's user cost formulae is to predict future house-price movements. The ADAM formula is basically

$$UC (ADAM) = \text{interest rate} + \text{taxes} + \text{depreciation} + 0.5 * \text{repayment rate} + 0.5 * \text{inflation}$$

There is no separate element for house price in the ADAM equation, and there is therefore much less variation than in our model in the results year on year.

**Table 8.5: User costs for owner occupiers in Denmark and estimated rents, 1980 - 2015**

Year	Housing expenditure	User cost including expected capital gains			140 m <sup>2</sup> house price DKK	Mortgage interest rate	Return on foregone investment, adjusted for risk	Tax on return on foregone investment *	Tax rate for mortgage interest deductibility	House price change	Property tax DKK	Land value tax rate	Maintenance	Private rent on 140m <sup>2</sup> home
		Scenario A	Scenario B	Scenario C										
1980	40,660	58,586			386,383	19.78%	23.38%	51.73%	56.10%	-1.38%	2,194	0.59%	9,350	16,380
1981	40,317	69,155			368,328	20.11%	22.55%	52.18%	57.00%	-4.67%	2,072	0.59%	10,596	17,920
1982	43,215	64,180	65,562		359,300	21.24%	25.11%	52.53%	57.70%	-2.45%	3,511	0.62%	11,648	20,020
1983	40,723	-44,926	30,164	37,160	438,744	14.97%	17.55%	54.73%	60.30%	22.11%	4,747	0.61%	12,451	22,260
1984	44,857	-19,427	-1,239	28,399	505,548	14.78%	17.12%	55.88%	61.50%	15.23%	5,766	0.59%	13,105	24,780
1985	45,396	-40,364	-47,775	3,243	590,408	12.03%	14.33%	56.03%	62.20%	16.79%	7,019	0.50%	13,939	27,720
1986	47,177	-19,543	-36,213	-23,177	662,629	10.77%	13.20%	55.93%	63.00%	12.23%	8,133	0.51%	14,531	30,520
1987	53,634	116,046	24,868	-3,521	610,269	12.55%	14.29%	53.64%	53.10%	-7.90%	6,229	0.54%	15,365	33,600
1988	52,215	56,542	53,710	18,857	619,296	11.26%	12.87%	54.24%	53.20%	1.48%	6,349	0.56%	16,307	36,960
1989	50,725	65,873	77,892	36,527	617,491	10.16%	12.70%	54.28%	53.00%	-0.29%	6,304	0.56%	17,398	40,600
1990	50,912	102,596	74,493	65,252	575,964	10.98%	13.63%	54.21%	52.90%	-6.73%	5,797	0.52%	18,310	44,660
1991	49,580	60,028	74,749	77,006	577,769	10.09%	12.27%	54.28%	52.90%	0.31%	5,819	0.50%	18,878	49,000
1992	49,532	75,401	78,052	70,020	563,325	10.14%	11.99%	54.47%	53.20%	-2.50%	5,679	0.52%	19,548	51,520
1993	46,444	40,078	56,040	64,840	580,405	8.07%	10.28%	54.50%	53.30%	3.03%	5,895	0.56%	19,782	54,040
1994	49,693	24,741	49,122	62,558	616,385	8.61%	10.85%	46.97%	49.10%	6.20%	4,466	0.55%	20,195	56,700
1995	54,450	35,427	37,738	53,000	648,130	9.38%	11.27%	46.09%	48.50%	5.15%	4,688	0.55%	21,138	59,640
1996	56,106	-12,709	15,971	37,359	723,450	8.44%	10.19%	45.58%	48.10%	11.62%	4,821	0.53%	22,073	63,245
1997	57,958	-15,520	-666	14,431	804,160	7.65%	9.26%	44.96%	47.70%	11.16%	5,474	0.52%	22,587	65,310
1998	58,218	-2,210	-17,232	-237	875,035	6.52%	8.03%	43.50%	46.30%	8.81%	5,904	0.52%	23,304	67,375
1999	64,731	-1,090	-8,788	-4,239	951,790	6.87%	7.94%	46.08%	43.00%	8.77%	6,077	0.53%	23,795	69,440
2000	76,959	29,598	14,821	1,328	1,014,685	7.45%	8.66%	45.73%	36.80%	6.61%	9,132	0.52%	24,375	72,263
2001	77,969	40,132	23,962	10,908	1,069,705	6.72%	8.09%	45.28%	34.20%	5.42%	9,627	0.50%	25,110	75,087
2002	78,026	61,093	41,970	25,855	1,106,315	6.33%	8.05%	44.61%	34.20%	3.42%	9,957	0.50%	25,697	84,560
2003	71,592	45,994	43,036	27,401	1,150,975	4.93%	7.31%	44.40%	34.10%	4.04%	9,957	0.49%	26,083	86,800
2004	71,210	-26,927	22,497	20,848	1,261,540	4.28%	7.30%	43.38%	34.00%	9.61%	9,957	0.51%	26,374	89,040

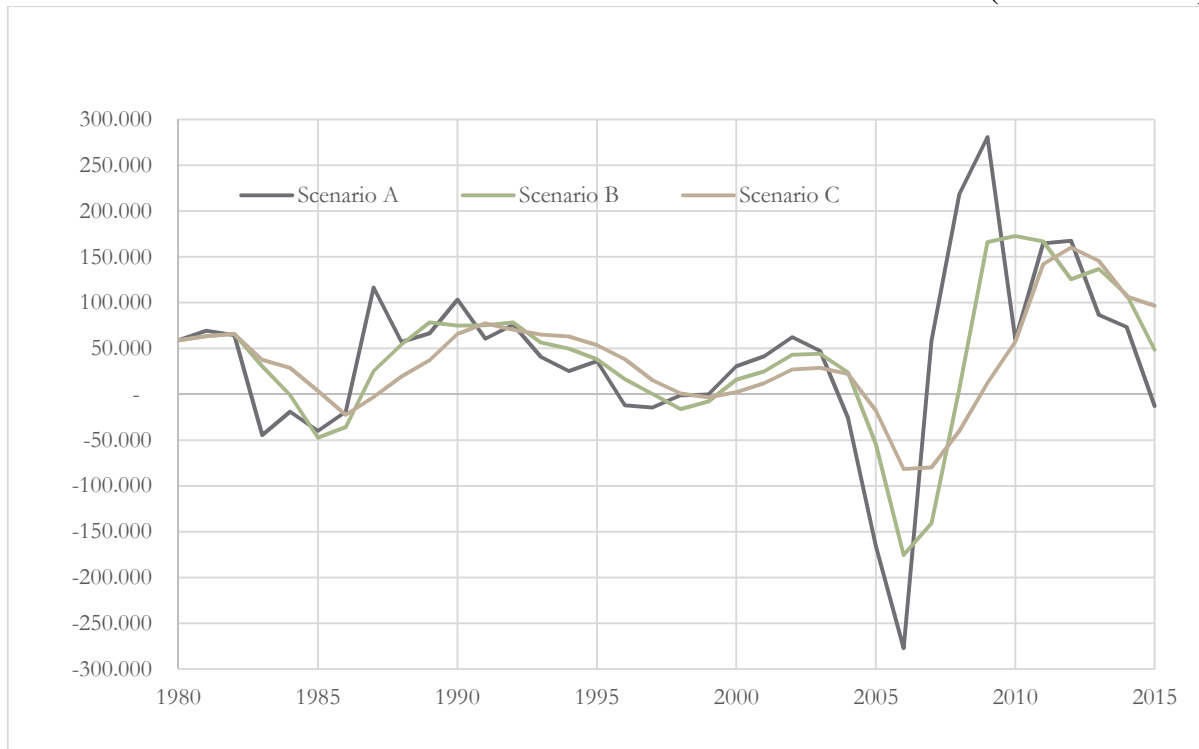
2005	75,759	-167,127	-55,827	-19,277	1,489,040	4.06%	6.40%	43.58%	34.10%	18.03%	9,957	0.49%	26,668	90,090
2006	92,830	-279,412	-177,504	-83,670	1,819,895	4.89%	6.81%	43.80%	34.20%	22.22%	9,957	0.47%	27,450	91,140
2007	105,125	56,322	-143,039	-81,810	1,899,695	5.81%	7.29%	44.01%	34.10%	4.38%	9,957	0.43%	28,677	91,350
2008	107,000	216,617	4,152	-42,109	1,819,685	6.27%	7.29%	44.32%	34.30%	-4.21%	9,957	0.40%	29,839	91,560
2009	79,725	278,847	164,199	10,676	1,629,180	3.90%	6.59%	42.84%	34.20%	-10.47%	9,957	0.36%	30,416	93,380
2010	75,440	57,541	170,885	55,252	1,674,960	3.27%	5.91%	37.31%	34.10%	2.81%	9,957	0.36%	30,619	95,200
2011	76,455	162,720	164,894	140,043	1,614,200	3.40%	5.71%	37.30%	34.20%	-3.63%	9,957	0.41%	30,940	99,559
2012	72,765	165,520	123,782	158,190	1,542,065	2.98%	4.36%	37.29%	34.10%	-4.47%	9,957	0.43%	31,888	101,445
2013	72,560	84,654	135,055	143,776	1,554,630	2.80%	4.74%	37.46%	33.63%	0.81%	9,957	0.45%	32,404	103,881
2014	71,528	71,135	106,666	104,816	1,578,710	2.54%	4.19%	37.45%	33.62%	1.55%	9,957	0.47%	32,749	105,273
2015	73,564	-14,904	46,817	94,394	1,684,153	2.49%	3.42%	37.69%	33.61%	6.68%	9,957	0.47%	33,334	106,482

#### Sources:

House prices	Average price/m <sup>2</sup> of houses sold on the market * 140 (average house size in m <sup>2</sup> ). 1992-2015 Realkreditaadet (Association of Danish Mortgage Banks), statistics code BM010; 1980-1992 Statistics Denmark EJENX.
Mortgage interest rate	1980-1987 fixed rate for 20-year loan (Abildgren 2005); 1987-2002 fixed rate for 30-year loan (Statistics Denmark DNRENTA); 2003-2015 weighted average of variable and fixed rates (Statistics Denmark DNRNR1)
Return on foregone investment	1980-1986 average interest rate on long government bonds (Abildgren 2005); 1987-2015 effective interest rate on 10-year government bonds (Statistics Denmark 1987-2011 DNRENTA; 2012-2015 MPK22) + 3% risk premium
Tax on return on foregone investment	Average tax rate on capital income (weighted by number of tax payers in each income bracket), corrected for the tax shield in place 1994-1998 and 2010 onwards.
Median rate of mortgage interest deductibility	1980 – 2012 median rate of mortgage interest deductibility for those with interest payments of over DKK 10,000 per annum. Statistics Denmark INDKFRF1. 2013-2015 maximum rate.
Property tax	1980-1999 author's calculations; 2000-2001 .09% of house value; 2002-2015 property tax fixed at maximum 2002 level
Land value tax rate	Overall national mean rate. Author's calculations of total actual tax take divided by land value tax base (from Statistics Denmark ESKATX and ESKAT) In 1999 these expenditures were found to be 2.5% of property value (Lunde and Hvidt 1999); other years author's calculations of median actual expenditure based on indices of property maintenance expenditure from Statistics Denmark (1978-2000 PRIS1; 2000-2015 PRIS6).
Maintenance in DKK	
LTV	Standard LTV of 80% used
Rent	Average rent/m <sup>2</sup> * 140 (average house size in m <sup>2</sup> ). 1980-1995 Rent Law commission report 1997; 1996-2001 Ministry of Social Affairs surveys, with interpolations for intermediate years; 2002-2010 rents calculated by Danish Rational Economic Agents Model (DREAM); 2011-2015 author's calculations based on Statistics Denmark figures on <i>all</i> rental housing and DREAM model

Table 8.5 and Figure 8.9 show that user costs for home buyers were negative—that is, that overall home buyers *gained* from house purchase—for a short period in the mid-1980s, and then again from 2004. They turned positive (indicating a cost to buyers) around the time of the global financial crisis in 2007 under Scenario A, and after 2008 under Scenarios B and C. The cost of homeownership under all three scenarios has been falling since about 2012 and is now negative under Scenario A.

**Figure 8.9: Three scenarios for user costs for home buyers in Denmark, 1980–2015 (Danish kroner)**



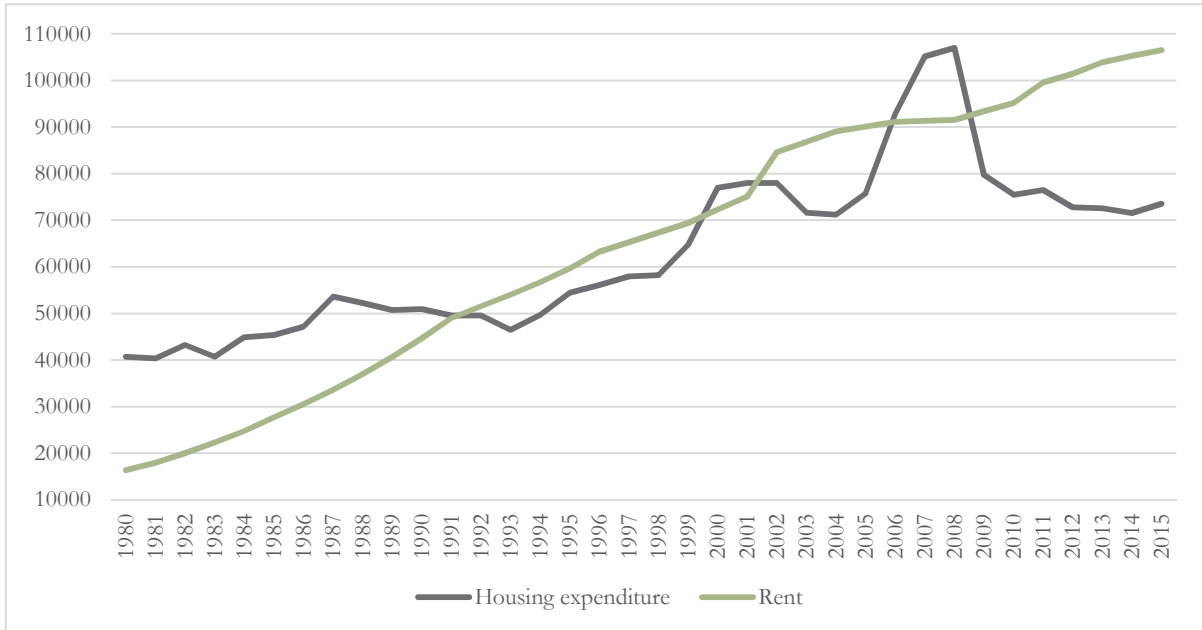
## Tenants

Figure 8.10 shows average rents and housing expenditures of home buyers on the same notional 140m<sup>2</sup> homes from 1980. This probably overstates true average rents, as rented homes tend to be smaller than owner-occupied dwellings. In the other three countries we have seen that rents rose relatively smoothly since 1996; this was also the case in Denmark, where the data allow us to look back as far as 1980.

Housing expenditures for buyers were much more volatile, nearly doubling in the ten years after 1993, but then falling significantly. Since 2009 rents have exceeded housing expenditures on this basis.



**Figure 8.10 Annual housing expenditure for home buyers and average private rents (both for 140m<sup>2</sup> dwellings) in Denmark, 1980-2015**



The picture in Denmark is once again different. It shows very consistent rent increases over a period from 1980 but also that in expenditure terms owner-occupation was relatively cheap throughout much of the 1990s and early 2000s and again after the financial crisis. First-time buyer user costs have been positive, except for periods in the early 1980s and again in the early 2000s. The very rapid rise, which started before the financial crisis pushed user costs far higher than had been experienced in the quarter of a century before but since 2010 these have been falling again as interest rates remain low and expectations of capital gains increase.

## 8.5 BENEFITS AND LIMITATIONS OF USER-COST ANALYSIS

The user cost approach allows us systematically to identify and quantify the various elements that contribute to the end cost of housing, and to carry out hypothetical exercises to see what would happen to relative costs if certain assumptions were changed—if, for example, the average loan-to-value ratio fell, or house prices rose, or rent controls were imposed. It helps us to understand which factors have the most effect on end costs and which are less important. It could illuminate the household's choice between buying a home and renting, or the property owner's choice about letting out. It provides a basis for cross-tenure comparisons within countries and could also, in principle, help us compare across countries.

However there are a number of practical difficulties with the approach, and for some questions, user cost analysis does not capture what we are interested in. There are four main problems:

1. *Data availability.* We found that in practice it was difficult to find data at the right level of disaggregation—or sometimes any data at all. For example, we had hoped to be able to compare user costs for similar dwellings across our four case-study

countries. In much of continental Europe house prices and rents are calculated on a per-square-metre basis, which facilitates comparisons. But in England, statistical sources usually categorise dwelling size on the basis of number of bedrooms, and floor areas can vary so much that it is impossible to produce prices per square metre. On the other hand, English sources provide disaggregated data about purchases by first-time buyers, which the other countries do not.

Even for comparisons within a single country, data availability was problematic. Per Question 1 above, we wanted to compare the relative user costs of renting and owning, looking at young households entering the market. This comparison is only genuinely meaningful if we can compare user costs for *the exact same units*, or at least very similar ones—the same size and type in the same location. However in practice much of the data for owner-occupation are from large national datasets that are not very disaggregated. Dutch house-price data, for example, are for *all* home sales, and rental data are for *all* new flats. User-cost calculations based on these figures just might accurately reflect the financial picture facing households choosing, at the margin, between renting and buying, but the likelihood is that such broad-brush comparisons obscure the genuinely decisive details.

2. *The question of time.* User-cost analysis looks at both financial flows and changes in wealth in a single year. This could be appropriate because it has been shown that people often base their housing decisions on expected costs over the short term. This short-term focus is particularly relevant if we want to compare private renting and owner-occupation. The initial monthly costs borne by private tenants and first-time buyers, which are well captured in user-cost calculations, may be similar

But although decisions may be based on short-term costs, housing is the ultimate durable good and in fact both costs and benefits will continue to flow for years or decades. In particular, a buyer normally builds equity while a tenant does not. Only a present value calculation could capture *all* expected costs and returns, including the mortgage being paid off after a period, transactions costs etc. Present value, which is equal to the flow of future user costs, also incorporates the element of *time*—which is crucial because returns depend significantly on how long the owner intends to hold the asset. This is particularly relevant in the case of housing because changes in capital values are volatile in the short term but more stable in the longer term, and because over a very long period expenditure on the mortgage falls away (assuming repayment mortgages) and capital increase becomes dominant.

We have tried to address the issue of time by using three different scenarios for expected house-price growth. However this does not offer an entirely satisfactory basis for comparison with renting as it still leaves open the question of which estimate is the relevant comparator.

3. *Ex ante vs ex post.* We were interested in employing user cost to understand how households decide whether to buy or to rent. For owner occupiers, the change in capital value of this house is one of the main elements of user cost - indeed, it can outweigh all the others. But at the moment of choosing between renting and buying, the household cannot know what path house prices will take in future. Of course, looking back we do know what happened to house prices, and can calculate *actual ex post* user costs (see Table 7.2 above). But this is not meaningful or useful for an

analysis of how decisions were made in the past. Even though we now do know what happened to prices in 2004, someone making a decision in late 2003 did not, and if we want to understand their decision we need to incorporate that uncertainty

This is why we produced three different scenarios for expected house-price change. But house prices were not the only unknown, and *ex ante* calculations are crucially influenced by the assumptions made. For example, for rental growth should we forecast the trend (over what period)? Use an average (over what period)? Some factors are largely or entirely politically determined—how to forecast them? We have set out the assumptions we made, but these may (indeed, probably will) turn out with hindsight to have been incorrect.

4. *Influences that are hard to quantify.* Finally, many of the factors that affect incentives to own or to rent are difficult or impossible to capture in user-cost equation—and indeed in net present value calculations. These include for example
  - Cultural attitudes to home ownership and the timing of initial house purchase
  - The individual's expectations about job security
  - The degree of tenure security in the PRS.

Given all these necessary caveats as well as the very considerable differences in how taxation systems and housing markets work in the four countries we need to stress again that we are not here aiming to make inter-country comparisons. Rather we are asking whether in each country there are clear differentials between the user costs of owning and renting which appear on the one hand to be related to changes in relevant market and taxation variables and, on the other, to changes in the tenure mix in that country.

## 8.6 CONCLUSIONS

Probably the two most important findings from the analysis were that data availability varies greatly across countries so that direct comparisons cannot be properly made; and similarly that markets operate in very different frameworks so the factors affecting outcomes differ between countries (eg fixed v variable mortgage rates; more or less regulated finance systems).

Over the periods of analysis there have often been relatively few policy changes - the exception is the Netherlands where there have been large changes since the financial crisis. On the other hand macro-economic conditions have been relatively far more volatile in part as a result of housing market behaviour in at least three of our case study countries.

Rental costs follow far more stable patterns than owner-occupation costs and have generally been rising. In Germany the increases have only been from the turn of the century and were relatively limited until the later part of the last decade. They rose slowly in the Netherlands where rent controls dominate but much more quickly in Denmark where rents are also regulated. Only in England are there no adequate data fully to track the pattern of rent increases until the last few years.

While it is not possible to achieve full consistency in measuring user costs of owner-occupation and particularly the first time buyers it is obvious that they are most obviously

affected by economic variables, notably by interest rates, inflation and house prices. How these variables impact on user costs depends on the tax framework in each country - particularly with respect to the treatment of mortgage interest and capital gains but it is the variables themselves that have dominated.

Finally both the period of rapid price increases in many countries in the early part of the twenty first century and particularly since the financial crisis user costs under whatever different assumptions have been particularly volatile. But this has also been a period of mortgage constraints so the numbers actually making decisions has generally been much lower than in the period before the crisis.

Overall, user cost and housing expenditure estimates provide useful information which can help clarify how housing markets are working but given data availability and the large number of factors driving tenure choice and housing market activity the results can only be indicative.

## Chapter 9: Conclusions

After decades of decline, private renting has started to expand again in many European countries, often as owner-occupation falls. There are exceptions, including Germany, where although the country has a well-operating private rented sector, owner-occupation is now expanding significantly through transfers from the private rented sector.

While the scale of the sector is very different across the four countries (Denmark 17 per cent; England 20 per cent, Germany 53 per cent and the Netherlands nine per cent), there are some similarities. Private rented dwellings are concentrated in cities and tend to be apartments; rents are generally higher than in social rented dwellings. Except in Germany, households living in the PRS have tended to be smaller, younger than average, and employed but on lower incomes than owner-occupiers. Institutional landlords are in the minority, sometimes a small minority. Dwellings are built specifically for renting in Denmark and Germany but can generally shift between tenures except in Denmark.

After the second world war, housing systems followed similar stages of development in all four countries:

- high regulation and low supply;
- improvement in the quality of the stock and growth in homeownership;
- reduction in supply side subsidies; and
- evolution of private renting as a substitute for and complement to social housing.

What has differed in particular is the path that private renting has taken. Germany first deregulated and then developed varying forms of third generation rent control; England moved slowly towards full deregulation in 1988; in Denmark and the Netherlands the sector has remained regulated except that around 1990 Denmark deregulated new build units and the Netherlands higher valued units.

In both Germany and England there have been significant transfers of social rented stock into the private rented sector. In Germany this has significantly been because of time limited subsidies as well as en bloc sales to private finance in some cities. In England it has occurred through the Right to Buy in that while initial sales are into owner-occupation a large minority of those units are now owned by private landlords. In Denmark and the Netherlands such movement has been almost non-existent.

On the other hand there have been transfers from private renting into owner-occupation and indeed into social renting in all four countries. Equally all four countries have seen slum clearance programme that impacted on PRS numbers. In both cases the impact has been greatest in England.

Since before the turn of the century in England and from the mid-2000s in Germany and the Netherlands but only to a limited extent in Denmark there has also been movement of stock from owner-occupation into private renting. Some of this movement has been a consequence of the global financial crisis but at least in Germany and England there appear to be more fundamental pressures involved.

England provides the most extreme example of how the PRS has grown at the expense of the two other sectors. From 2001 to 2014 – a period when almost 2 million new dwellings

provided the vast majority for owner-occupation or social renting both of these sectors declined over the period –while the PRS expanded by 2.6 million units, more than doubling the size of the sector. This has reflected increasing constraints on access to other tenures as well as the effect of lower inflation and greater housing market risks.

## 9.2 INCENTIVES AND CONSTRAINTS

It is important to clarify that in all four countries the PRS, and indeed the housing system as a whole, was nowhere near equilibrium after the second world war. There was heavy regulation which constrained choices, massive shortages of supply and heavily regulated finance systems which constrained both consumer and landlord choices. In many ways, although systems are far more choice based than they were, there is still continuing disequilibrium – which means that, for instance, even if conditions improve for investors in the PRS they may still not want to invest; equally people may be forced into the PRS because of constraints on access to credit which do not reflect their underlying capacity to pay or because, even though eligible, they cannot access social renting. On the other hand many households may choose the PRS for positive reasons and new investors into the sector are free to choose to invest there or in other investments such as the stock market or bonds.

Because of these complexities we expect the size and role of the sector to be determined by a wide range of drivers and that the relative importance of these drivers will change over time. How these operate in different countries and different circumstances within each country is the central theme of this research and report.

The main drivers identified in the literature and from roundtable discussion include:

1. the PRS regulatory framework and changes in that framework;
2. the tax and subsidy framework for the PRS and for alternative tenures;
3. the economic environment in which decisions are made;
4. the interaction between economic variables and other incentives- notably the tax framework;
5. constraints on entry into other tenures;
6. attitudes to the sector arising from past experience, the type of stock available; tenms and conditions and other factors.

### *Regulation*

There are clear differences in the form of regulation currently in place across the four countries. At one extreme in England the system is highly de-regulated with market rents and short term security of tenure; at the other Germany has until lately had a very stable system of lifetime tenure, market rents at the beginning of the tenancy and in-tenancy indexation. Both should in principle enable considerable freedom of choice for both landlord and tenant – at least in a stable economic environment. In Denmark and the Netherlands there remain very considerable rent controls for the majority of the sector, incentivising landlords to leave that sector if they are able to do so and have alternative investments available.

### *Tax and subsidy framework*

Germany is atypical in having a near tenure neutral system and in financial terms very limited subsidies except for low income tenants. PRS is treated as an investment good which enables landlords to choose between property and other investments on a relatively level playing field.

The tax systems in the Netherlands and Denmark and now to a lesser degree in England favour owner-occupation for households, particularly in periods of rapid house price and general inflation when housing investment acts as a hedge against loss of value elsewhere<sup>12</sup>. The PRS is generally treated as an investment good but in England property is regarded as a perpetual asset and there are other constraints on allowances. In all four countries tenants are eligible for income related benefits.

### *Economic variables and their interaction*

Economic variables are important in their own terms – for instance in general income growth has both enabled and incentivised choice and owner-occupation; interest rates help determine affordability; better off households tend to want to have control over their own home. But economic variables also interact with the tax subsidy and regulatory frameworks to change incentives – so for instance rent regulation is less of a disincentive if costs are predictable and house prices stable or falling. Finally particularly because housing is a longer term decision, households and investors are concerned about risk and volatility – eg whether they will remain in employment and able to pay the mortgage; whether house prices will go down and so on and this impacts on decisions by all types of stakeholder.

### *Constraints on entry into other tenures*

Again Germany is the outlier with almost no social housing and continued regulation of mortgage credit. Private renting is thus not only relatively desirable because of the stability of the regulatory framework and the economic environment but because other options are not readily available.

In the other three countries liberalisation of the mortgage market has allowed large numbers of households to enter owner-occupation while social housing has been relatively easily available in the Netherlands and Denmark for a relatively wide range of households except in areas of housing pressure. Post 2008 there have been some problems both in terms of access and adjustment in the owner-occupied market especially in the Netherlands which has increased both demand and supply of PRS housing.

England is the outlier at the other end of the spectrum with a declining social rented sector such that the PRS accommodates many more vulnerable households, With respect to owner-occupation the expansion to 70 per cent of all households at the beginning of this century has been followed by a rapid decline to around 63 per cent in part because of constrained access to mortgage funds and worsening affordability but also for more positive reasons as the range of properties available in the PRS has expanded.

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<sup>12</sup> There are now additional entry subsidies

### *Attitudes (preferences)*

These are often set by past experience which is clearly more positive with respect to the PRS in Germany while in the other countries it was increasingly seen as the residual sector except for young and mobile households. Arguably this is changing but it is difficult to separate these shifts from those arising from the other drivers listed above.

### **9.3 FINDINGS FROM AN ANALYSIS OF USER COSTS**

User cost analysis was developed to address the issues around changing incentives to invest in owner-occupation rather than specifically to look at the issues of tenure choice. What we have done therefore is to calculate user costs for the three comparator countries and examined the trends in these costs in relation to the timing of key changes in incentives and constraints for each country .

There are major problems with respect to data which mean that the detailed analysis can only be made for later years.

While the user-cost analyses give some very general indications of the relative benefits of different tenures over time, this technique has some serious drawbacks when used to addressing these questions. These include:

- a proper comparison would be looking at exactly the same units while we know that in fact the dwellings in the two tenures are often very different;
- the question of whether to live in a property versus letting it out is generally answered at the time of purchase. Equally the investor can only live in one unit. It is better answered by examining whether it is profitable as compared to other possible investments (sub-question 3);
- user costs are measured at a point of time – they are not present-value calculations as would normally be employed by investors; and
- our calculations are generally *ex post* although decisions have to be made *ex ante*.

The findings are quite limited and suggest that

- most changes are slow burners – the impact will be felt over many years
- there are often too many changes going on at the same time to separate out the impact of any one change – the system works as a whole
- because systems are often still out of equilibrium when the change occurs, the impact is not as expected or not as large as expected
- in the main it is the economic environment and how it interacts with other drivers that shows the greatest impact..

Only one change can be identified as having a clear immediate impact: the buy to let mortgage introduced in the late 1990s in England which clearly overcame an important credit constraint within the sector.

On the other hand a large number of changes aimed at helping institutional investors across countries have as yet had almost no effect – suggesting that returns are not yet adequate to change behaviour.



## 9.4 IMPLICATIONS FOR DENMARK

This story of private renting in Europe since the Second World War is one of changes in rent regulation and to a lesser extent modifications in tenure security. These changes took place in very different economic contexts both across countries and over time. The eventual outcomes in each country depended on two things: the capacity of existing landlords and tenants to adjust to changing circumstances; and the incentives and capacities of potential investors and tenants to enter the market when conditions were attractive.

Denmark is unusual among European countries in having a system where the tenure of dwellings is determined at the time of construction. As a result most private buildings with three or more units were built for the private rented sector. Compared to many other countries, Denmark has seen relatively few transfers of rented stock to the owner-occupied sector and, since the crisis in particular, some transfers from owner-occupation into private renting of single family homes. There is also a growing movement into co-operatives especially in Copenhagen. This mirrors experience in Germany and especially Sweden (Whitehead et al, 2012).

Denmark is also unusual in that national rent deregulation enacted in 1991 was limited to new buildings. Pre-1991 units are still subject to strong rent regulation and all types of rental housing are also subject to local regulations in some areas.

The evidence from the three other countries on the effects of rent regulation varies, but overall suggests that traditional rent controls will normally incentivise landlords to exit the market by selling into owner-occupation or some form of condominium. The strength of that incentive depends on the form of rent control – in particular, whether and how rent adjustments can occur and how they affect returns compared to alternative investments. The extent of movement out of the sector also depends on how constrained landlords' options are. So initially in England, when some decontrol was introduced but security of tenure was maintained, many landlords were 'forced' to remain in the sector. Later when they were able to gain vacant possession they had the option of selling into owner-occupation.

Germany has a more sophisticated form of rent stabilisation in which the market sets initial rents but rent increases within a tenancy are related to defined external factors such as an index of inflation. Together with a strongly regulated financial system, a relatively generous tax framework and a stable economic environment, this means private renting is still the best investment option for a wide range of landlords and has resulted in a healthy market for both landlord and tenant. In the Netherlands, where the points system means that units must rent for less than about 700 Euros per month are controlled, there has been very little new investment into private renting. The sector is now the smallest in Western Europe at around nine per cent of the stock, even though higher rents are market determined. Those landlords that remain are often small companies set up decades ago and many of the founders are trying to sell up as they reach retirement.

The extent of *new* investment in the PRS – whether into newly built units, transfers from other tenures or investment in repair, maintenance and improvement – reflects investor choices based on the expected rate of return on that investment compared to other possible opportunities. In Germany, investment in energy-efficiency improvements allows landlords to raise rents by a considerable amount, so many see it as worthwhile. In England, market-determined rents, lack of security of tenure and (in some parts of the country) significant

capital gains, plus the wider economic context of low interest rates, together have created an incentive for individuals to invest in the private rented sector. Many of these investors view rented property as a vehicle for long term savings for old age. The result has been rapid growth in the private rented sector especially since the turn of the century (Scanlon, Whitehead and Williams, 2016).

### ***The potential for institutional investment in the private rented sector***

Many European governments seek to increase institutional investment in the private rented sector sometimes with the help of tax reliefs, guarantees and other support. They see institutions (pension funds, insurance companies, etc.) as providing not only private funding (which might reduce the need for public sector involvement) but also stability and quality in provision. It is generally accepted that if they are to invest, institutions require four conditions:

- a suitable stock of purpose-built units to allow cost efficient management and provide flexible accommodation for tenants;
- rents that rise with tenant incomes, so matching the structure of the institutions' outgoings;
- the assurance that they can gain repossession if the tenant fails to meet the terms of their contract; and
- a stable tax and regulatory framework.

Institutions normally do not take on development risk, and try to avoid both reputational and policy risk.

A system with indefinite tenancies (which are associated with low turnover and therefore low vacancy rates) and in-tenancy rent stabilisation in a low-inflation economic environment (so there is little chance of cost inflation) can provide a suitable framework for institutional investment. Within this framework, institutions still of course require a risk-adjusted yield that is in line with other asset classes. Their main competitors for the purchase of residential property are individual investors; if such investors are willing to accept lower yields (and therefore pay higher prices) then institutions will go elsewhere.

Over the last few years institutions have becoming increasingly interested in the residential property market, and in all four countries interviews suggested that there are 'shedloads of money' waiting to enter. Yet so far the evidence is that very little has actually been invested.

The country that best meets the requirements for institutional investment is Germany: it has a long history of economic and regulatory stability and the tax system is relatively generous towards landlords. Even so, most landlords in Germany are individuals or small companies and there has been little institutional activity, except to the extent that private equity has purchased social rented stock. The Netherlands has some apparently attractive new stock for investors at the upper end of the market in high-demand areas, notably Amsterdam. This has attracted some limited investment, but the general framework of regulation and recent changes in policy towards large landlords have made that market seem relatively risky. In England there has been rapid growth in the sector but there is little existing stock that meets institutions' requirements; most new sites are multi-tenure and there is very little purpose-built PRS stock. Most importantly, owner-occupiers are generally prepared to pay more for individual units than institutions would, in part because of expectations of capital gains but

also because of the tax framework. Institutions therefore tend to require assistance from government (eg through the provision of cheap public land in return for an agreement to keep the units in private rental for a specified period) before they will invest.

If institutions are to increase their investment in the PRS, all the incentives must be aligned. While each of the three comparator countries has a unique set of circumstances, none is yet investor-friendly enough to have attracted large-scale institutional involvement. This may be changing, slowly. There is evidence that required yields have declined, in part because of declines in the returns available from other assets. This has led to some 'niche' investment, notably in central cities and/or high-rise blocks. And governments have taken some steps to make the investment environment more attractive. But, overall, residential property continues to be a very small sideline for most institutional investors.

### ***Growing demands for private renting***

Finally there is the question of demand. In all three comparator countries there is evidence of growing demand for private renting, at least in major cities. In England the increase in demand is evident nationwide.

The growth in demand comes from a number of drivers, including in particular shifts in economic activity that have increased the incentives for younger people and more mobile households to locate in big cities and university towns. Secondly, the very considerable growth in the number of students (both national and international) in higher education has led to increased demand for student privately rented accommodation – and this is the only subsector of the market to have attracted large-scale institutional investment across a number of European countries, because it fits within the norms of commercial property. Third, there is some evidence that younger households are increasingly choosing to rent, partly as a result of the more risky environment, partly because of increasing credit constraints, and partly because of better choice in the sector. Most such households are not eligible for social housing, so their behaviour change increases demand for private renting.

In Germany these shifts in demand have been muted, mainly because so many people have normally lived in private renting. Also, these pressures have been offset by declining demand among those able and willing to purchase their homes, who have been attracted by increasing house prices (hitherto unusual in Germany). Even so, in some cities there is massive excess demand with people finding it hard to obtain access to privately rented accommodation. Rents for new lettings are rising rapidly in these areas, which has led to pressure for tighter rent controls.

In the Netherlands it is relatively easy to become a social tenant except in the high-demand areas around the capital and Amsterdam. Demand in these areas is clearly growing, but this is offset by declines in the private rented sector in other regions, resulting in overall shrinkage at national level.

England is by far the most extreme example of demand being concentrated in private renting, with large numbers of younger households unable to enter either owner-occupation or social housing. As a result both demand and rents have grown in quite large parts of the country. Supply has come mainly from transfers from other tenures, with only a limited amount of new build either for buy-to-let landlords or institutions.

In much of Denmark there is social housing available for the sorts of households who would be private tenants in other countries. There has been some transfer of private units into co-operatives meeting similar needs, and equally some very limited movement of single-family homes into rental from owner occupation. Again most of the new demands are concentrated in Copenhagen, which has some new developments for upmarket rent. The Danish market is similar in many ways to that of the Netherlands, but there would need to be significant changes in opportunities before major investment could be expected.

Overall the potential, and in some cases actual, importance of private renting is growing rapidly. However none of the four case-study models has yet demonstrated the ability to generate significant additional investment. Instead, in those countries where units can be readily transferred between tenures, high relative returns has led to increased transfers rather than to dedicated new construction. In other countries, especially those where there are calls for stronger rent controls, new tenants are finding it harder to access rented housing at rents they can afford while institutional investor interest in particular has flagged.

Into the future, as younger households make different life choices, access to credit remains restricted and government budgets for social housing come under increasing strain, private renting is likely to grow. The objective must be to provide a tenure neutral environment in which tenants, landlords and investors are all in a position to make the choices that best meet their objectives. This requires considerable new investment particularly in thriving central city areas. Most importantly it requires governments to provide stable regulatory, subsidy and taxation frameworks that allow all tenures to make effective contributions to ensuring adequate housing for all.

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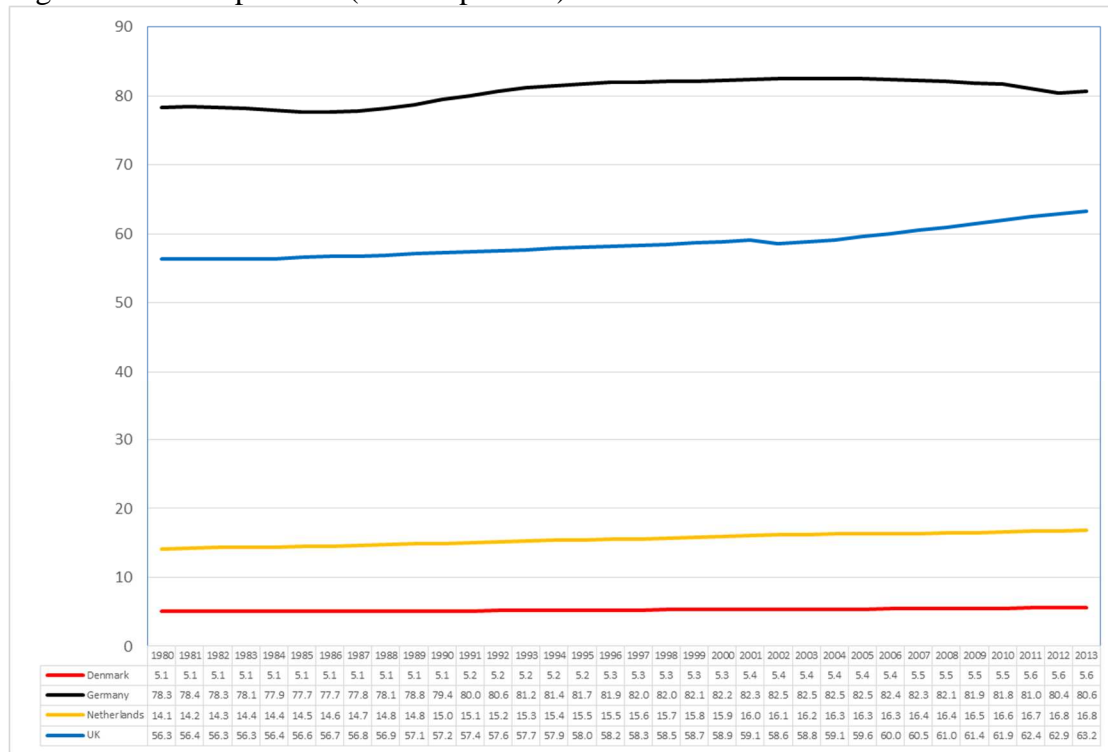
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# Annex 1: Background statistical data

Annex 1<sup>13</sup> provides background statistical data for the four countries. It shows that for there are very considerable differences in trends between the countries for many of the variables but that for interest rates in particular there is a fairly consistent pattern.

Figure A1 Population (million persons)

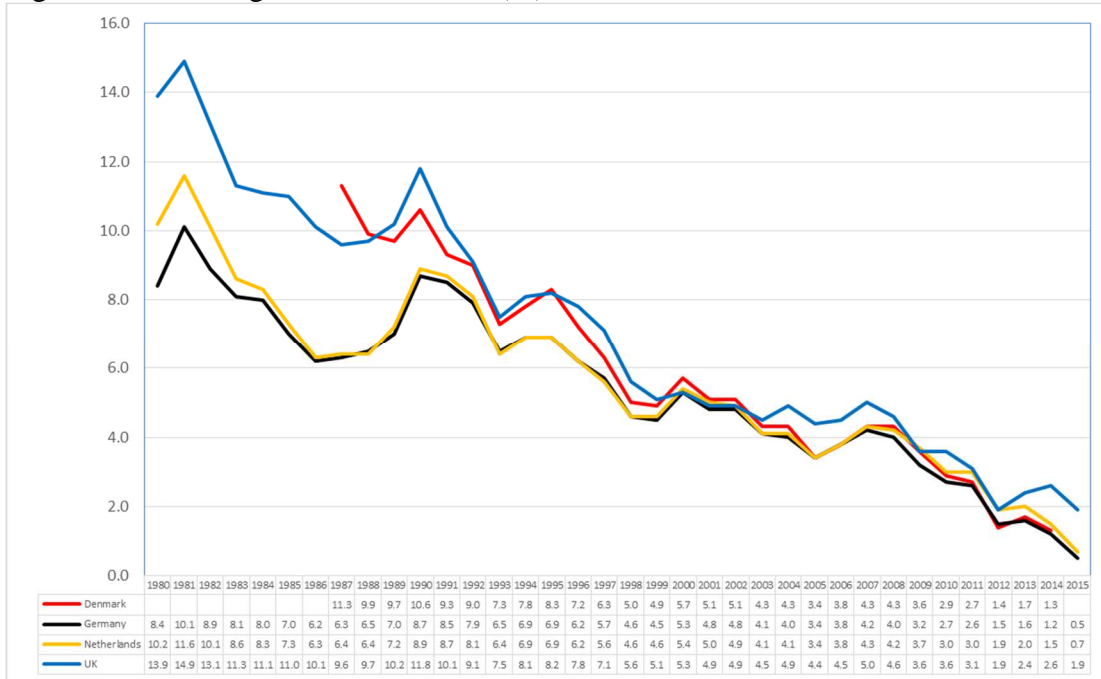


Source: OECD

<sup>13</sup> Germany was created on 3rd October 1990 by the accession of the Democratic Republic of Germany to the then Federal Republic of German).

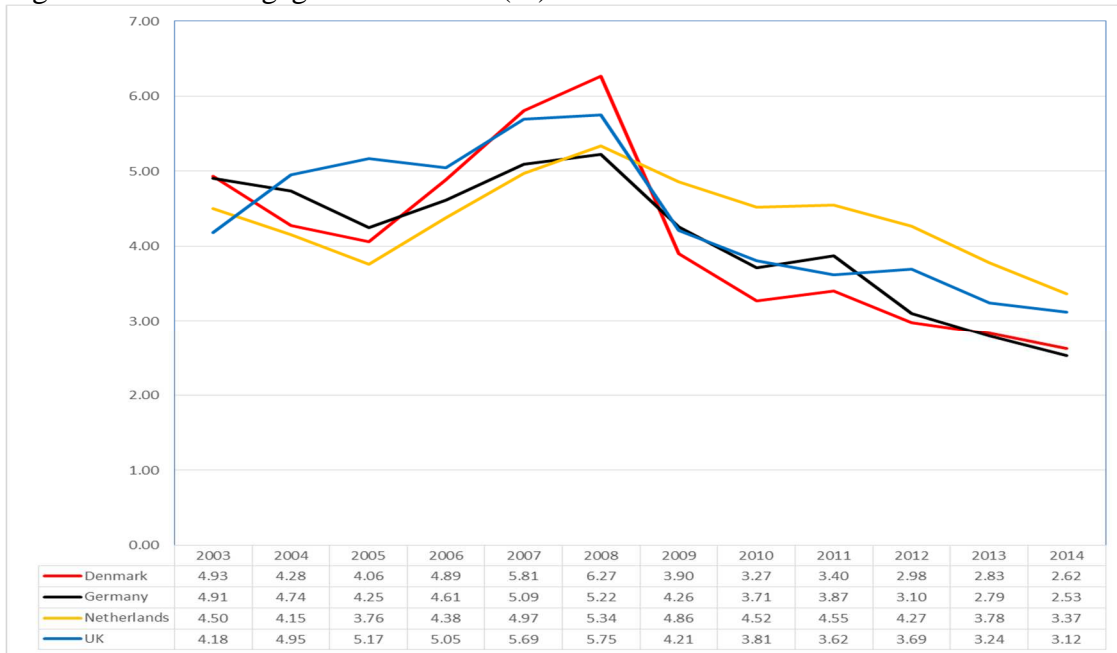


Figure A2 Long term interest rate (%)



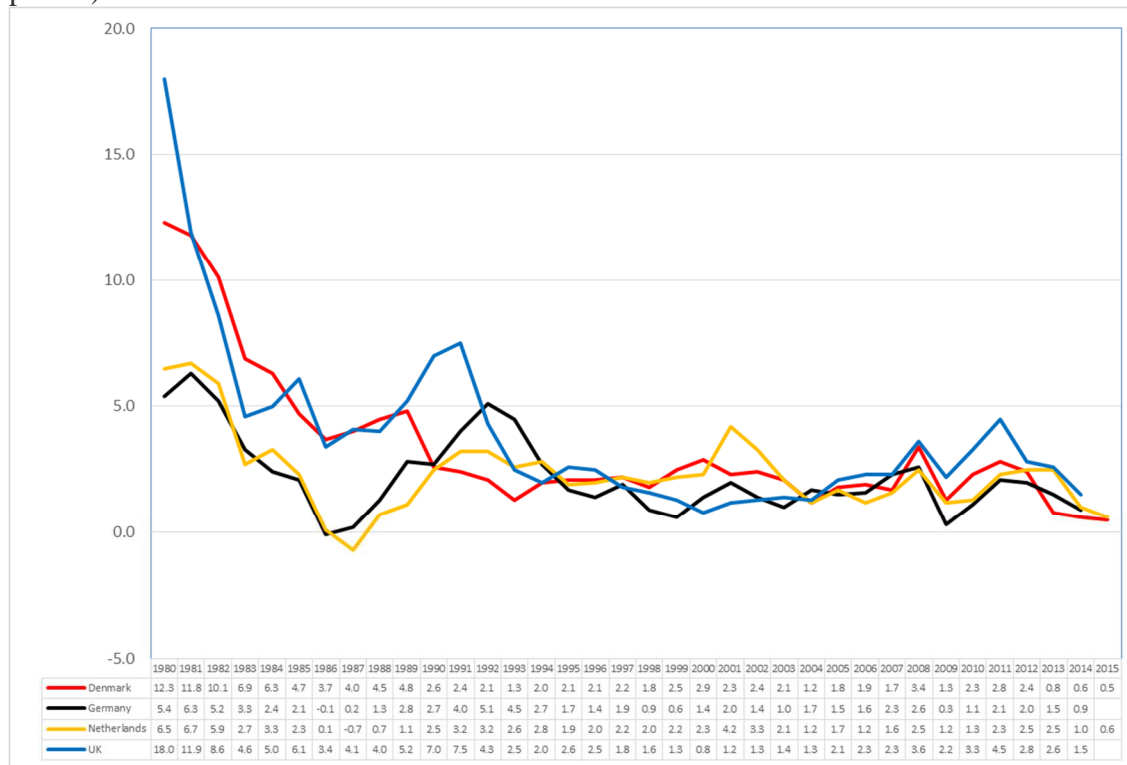
Source: OECD.

Figure A3 Mortgage interest rates (%)



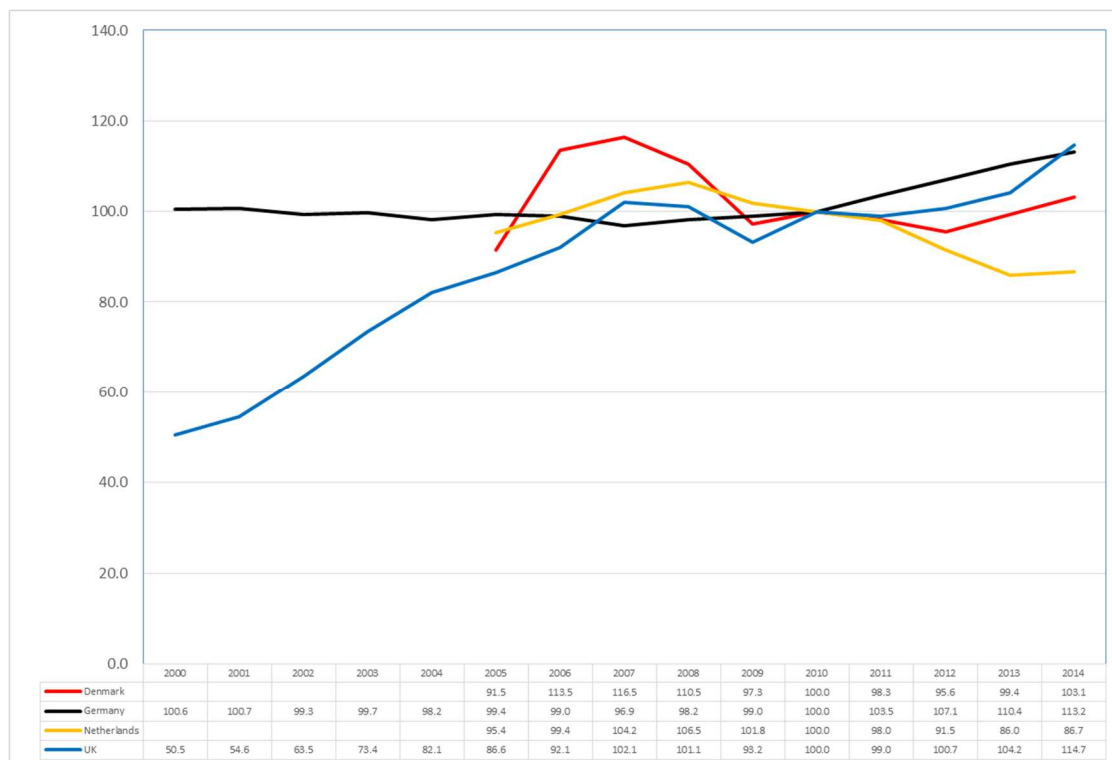
Source: European Mortgage Federation

Figure A4 Inflation rate (%: Consumer prices: all items. Growth over the previous period)



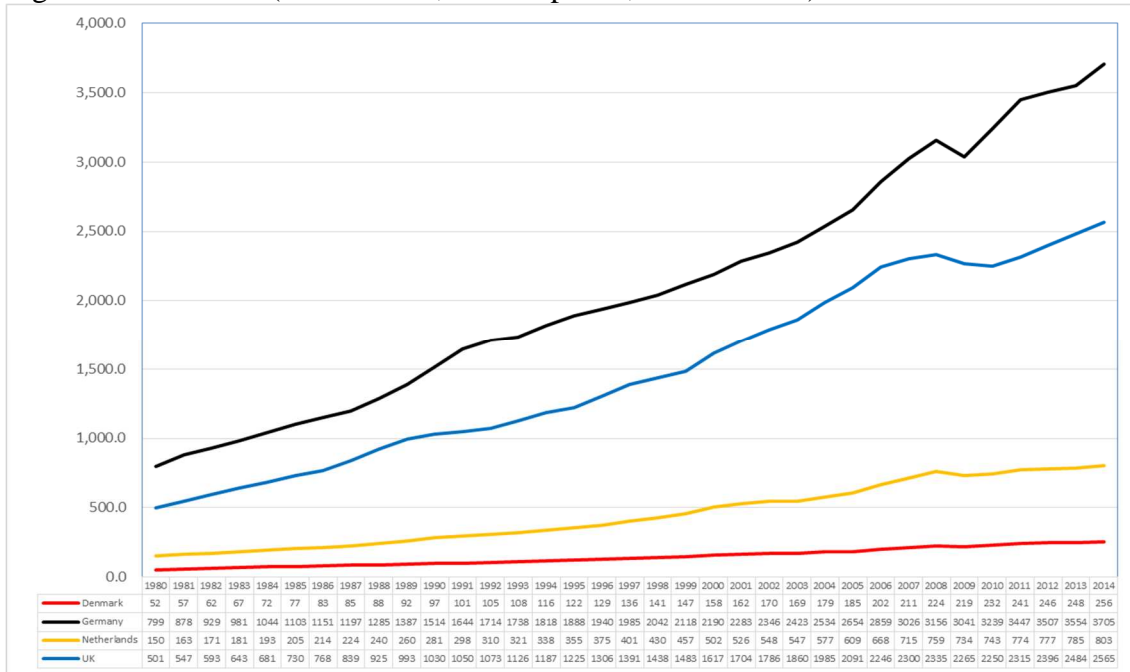
Source: OECD

Figure A5 House price index (2010=100)



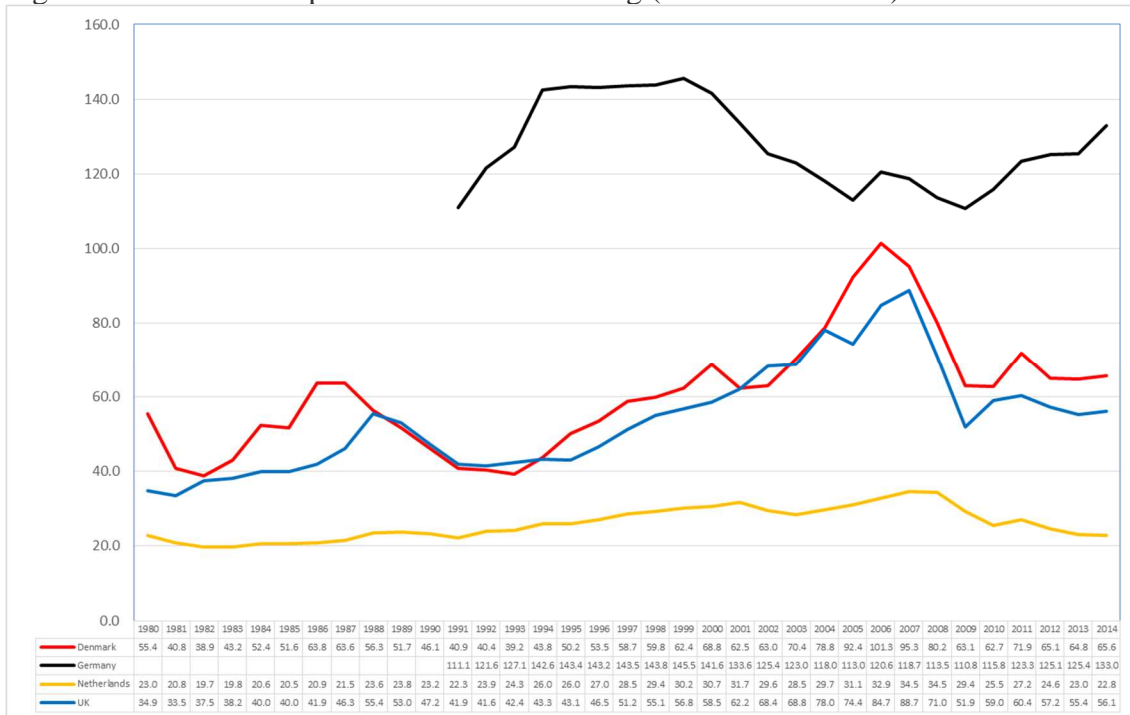
Source: OECD

Figure A6 GDP (billion USD, current prices, current PPPs)



Source: OECD

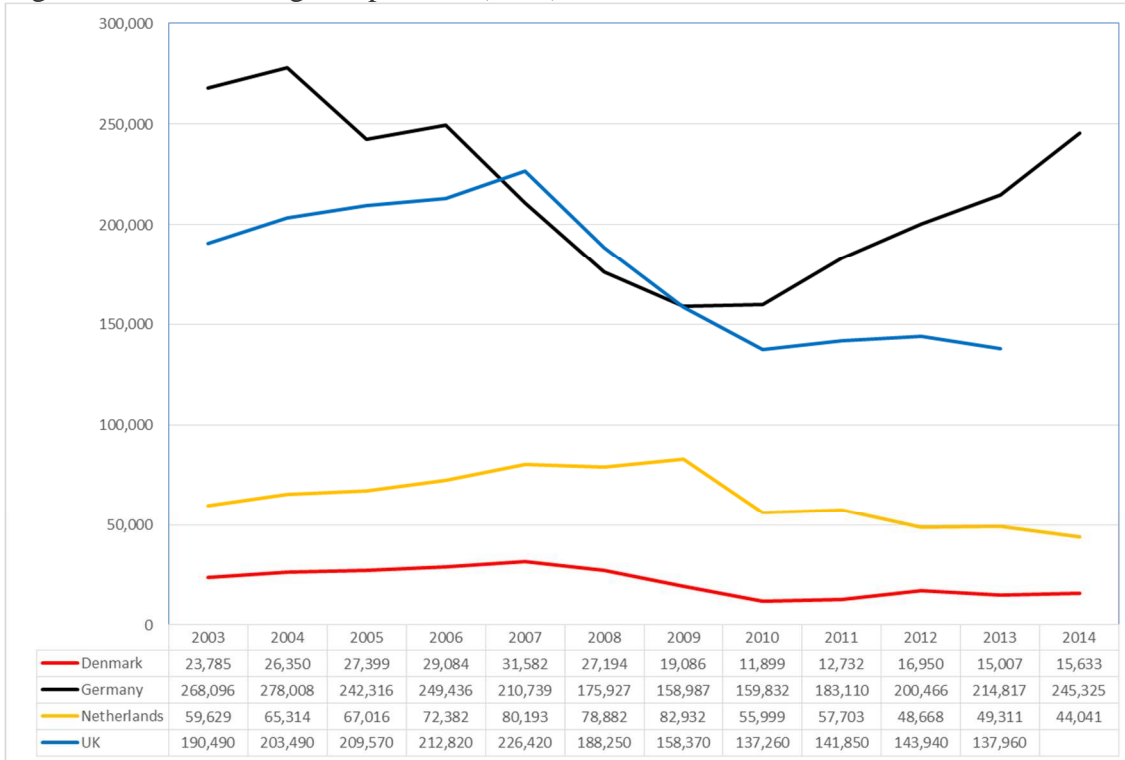
Figure A7 Gross capital formation in housing (volume in million)



Note: Real Gross fixed capital investment in housing is measured by the total value of producers' acquisitions, less disposals, of new dwellings.

Source: OECD

Figure A8 Housing completions (units)



Note: Number of new residential construction projects that have been completed during a given period. Housing Completions is directly integrated into the dwelling stocks and, as such, is a determinant of the housing supply.  
 Source: European Mortgage Federation.

## **Annex 2: Workshop findings**

### **A2.1 Key findings from the workshop on private renting in England held at the London School of Economics on 16 December 2013**

The purpose of the workshop was to discuss the growth of private renting in England and to identify the challenges and barriers that exist to increase the supply of private rental dwellings and how these may be overcome. Some twenty participants were invited based on their expertise in the investment in and the management of private renting in England. They represented a wide range of practitioners from policy makers in the Department of Communities and Local Government, to representatives of institutional investors, academics, consultants, developers, housing associations and independent experts.

The half-day workshop, held on 16 December 2013, was divided into four sections that included presentations from the project team.

#### **Section 1: What has caused the growth of the sector in England – is it structural and potentially long lasting or an outcome of cyclical pressures arising from the financial crisis?**

The presentation examined the growth of the private rented sector (PRS) in England and identified the following specific factors that contributed to this growth:

- Deregulation of rents in 1988 led to a very slow increase in supply
- Introduction of Buy-to-Let mortgages in 1996 – the PRS started to increase quite quickly
- Global financial crisis in 2007 – sellers could not sell and purchasers could not buy so the PRS grew rapidly while new supply fell by more than half

However, none of these alone was responsible for the growth of the sector. Other important factors were the high cost of owner-occupation and the availability of the Local Housing Allowance. These two factors sustained the growth of the PRS as a tenure suitable for would-be first time buyers as well as for those who would prefer social housing but do not have sufficiently high priority. The PRS has also increasingly been used for temporary and more permanent accommodation by local authority Housing Options services.

The vast majority of the expansion of the sector has come from transfers from owner-occupied and social sector stock. Under Buy to Let some new developments were sold into the PRS especially after the turn of the century but to a significant degree the PRS allows higher occupancy rates in the existing stock as opposed to increasing the overall housing supply.

#### Response

A participant pointed out that in 1997, the Labour government promised there would be no new regulation in the PRS and this helped to build the perception that the PRS can be seen as a long term investment. In Germany, regulation achieves a balance between the interests of tenants and of landlords at least in most places. In the UK the free market gives poorer households little bargaining power in pressured areas. There is some pressure to introduce a German style in tenancy rent regulatory framework but this is seen by many as likely to

undermine confidence. A study commissioned by the Homes for Scotland identified the following issues which may affect investment in the PRS in Scotland:

1. Independence vote in September 2014, so investors are waiting to see what happens
2. Fear of rent controls and regulations on security of tenure
3. The tenure has a poor reputation, with surveys reporting poor maintenance, absentee landlords and anti-social behaviour
4. Local authorities have negative views on the PRS which is often seen as a tenure with many problems including low compliance with health and safety regulations (which they have to enforce).

In the Netherlands, the PRS (of dwellings with a regulated and a deregulated or liberalised rent) is less than ten percent of the housing stock. Institutional landlords have continued to invest in their properties and kept their small market share relatively stable since WWII, while individual landlords have left the sector. Simply said, this is because institutional landlords received the same subsidy as social landlords but individuals did not.

In Germany, there has not been much institutional investment – only ten percent.

In England, since 2000, owner occupation has been taxed as a consumption good, not as an investment, so there is no mortgage interest tax relief. In contrast, private landlords are treated as investors. For investors, property investments can be more attractive than annuities and equities. Similarly, in the USA, investors are switching from commercial to multi-family units, and the residential investment market is now the same size as the office market.

Of concern is the extent to which rents in the lower part of the UK market are sustained by Housing Benefit. Under Universal Credit it was found that the average household needed £38,000 per annum to get off benefits, which is well above the median household income. Also, a couple with children would need £90,000 in London – this is unlikely to be a sustainable system.

The government's Build to Rent scheme is an attempt to provide funding for developers looking to provide new investment in the sector. It arises out of the Montague Report and has brought new landlords into the sector.

## **Section 2: Have the barriers to investment in private renting been overcome to the point where the sector can undertake significant new investment?**

Attracting institutions to the sector has long been an important policy aspiration. The presentation identified four main barriers to institutional investment in the PRS.

### *Land*

Institutional investors have argued that the yields from the PRS are too low and that owner occupation will always be more profitable and so will determine the land price. This makes it impossible for the PRS to compete for land. It is also argued that the supply of land in the right locations for private renting is extremely scarce. Local authority planning policies are not conducive to private renting, and there is a lack of development finance for new build rental units.

### *Investor attitudes*

Barriers related to investor attitudes include the unpredictability of demand in the longer term, investors' mandates (industry benchmarks), and a lack of expertise in the sector within investment companies. There are also concerns about management and reputation.

### *Yields*

Barriers related to yield include the illiquidity of residential property, the lack of robust market information, management costs and capacity, and the scale of the potential investment that is required.

### *Risks*

Investors are risk averse when it comes to planning and development. There are also reputational risks associated with the PRS and regulatory and policy risks – e.g. that the government might re-introduce rent regulation or change the nature of leases.

However, there are some signs that these barriers may be being overcome. Although there are few new dedicated PRS developments to date, there is increased interest, government programmes are starting to bear fruit, and a new policy proposal in the Draft London Housing Strategy is for new homes to be covenanted for private rental for at least ten years. However the experience of early investors such as Genesis and QDD will be very important<sup>14</sup>.

### Response

It was generally felt that it was too early to say whether the barriers have been overcome. All are watching the Olympic site. A delegate from the PRS Task Force said that there is a lot of activity, both from developers and from those wanting to provide investment finance. Grainger plc is the only one taking risk so far.

Sigma Capital Group has signed a deal with Gatehouse Bank<sup>15</sup> to deliver new private rental properties, initially in Manchester and Salford. It has stated that there is a lot of interest in the North West of England because land values are lower and yields better. Overall, returns across the world are coming down and becoming more volatile so PRS/residential investment becomes more attractive in comparison. Referring to management costs, in general, once a portfolio reaches a certain size, investors usually outsource the management because it is cheaper. Typically, private landlords do not know the ratio of their rents to their costs. In practice, running costs can be very high.

It was pointed out that existing housing management approaches are not suitable for managing private rental units on the Olympic site. A new approach is required that is more like hotel management and includes concierge and extra services. On the management side, reputational risk is an issue. The RICS has now produced a guide on how to manage new, modern private rental units – for what is practically a new sector.

The Olympic site was not originally designed for the PRS. So there are management problems associated with the Olympic village. For example, there is a maximum of 40 new lettings a week because there is no separate goods lift. This constrains the number of moves

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<sup>14</sup> Investment in the Olympic site is being carried out by QDD, a joint venture between Qatari Diar and Delancey, and Triathlon Homes, a joint venture between First Base, East Thames Group and Southern Housing Group.

<sup>15</sup> Gatehouse Bank is Sharia compliant, making it suitable for Islamic investment.

that are possible each day/week. Sharing the infrastructure with social tenants is also thought to be an issue for private tenants.

### **Section 3: Are new initiatives likely to generate significant investment?**

The presentation introduced the following government initiatives that might stimulate/reduce private investment in the PRS:

- Build to Rent fund
- Affordable homes guarantee programme
- Support for long term private renting
- Initiatives that may reduce PRS investment

#### Responses

It was pointed out that local authorities do not always have positive attitudes about investment in the PRS. The development of the PRS is seldom included in their Housing Strategies. There has been a perception that private renting will reduce the value of the land. Also, land identified specifically for the PRS is thought to hinder the conversion of that land to owner occupation when the housing market recovers. In general, it was felt that local authorities need to understand the private rental market in their area. The PRS has a different socio-economic profile from both owner occupation and social renting.

However it was felt that most of the barriers to investing in the PRS would fall away if the market gathered sufficient momentum.

### **Section 4: What role will private renting play in meeting overall housing investment requirements in the future?**

This was an open discussion. Key questions covered included:

- Does the PRS bring social benefit? There is only the infant industry argument, which is weak in the context of the PRS.
- The PRS competes with owner occupation in different housing market conditions.
- Is there a scale issue? How much government investment is necessary to gather the momentum to encourage institutional investment in the sector?
- This is linked to under-investment in housing overall – currently, the government is trying a whole range of initiatives to see what happens.
- Tax treatment – so long as there is a different tax treatment between owner occupation and private renting, government initiatives to encourage private renting will be problematic.

#### **Conclusions**

The PRS needs to reach a critical mass if it is to be attractive both to renters and investors. Tax incentives can play a key role in stimulating investment in the PRS. There is a need to distinguish between those investing in the sector by providing finance and those who are developers and/or landlords. As rent regulation has reduced, investors of both types have seen the PRS as a solid investment. However, this is likely to change as the housing market begins to recover.



While many of the barriers to institutional investment in the PRS appear to be beginning to recede, others reflect specific features of the UK planning system and property market, which will be slow to change.

Nevertheless, as people have poorer access to finance and see greater labour market and housing market risks because of post crisis recession and now the low growth in real incomes, the PRS has become an important tenure. This is particularly true for younger people who cannot access owner occupation but there are also growing numbers of families in the sector. For the majority households in this second group living in the PRS appears to be more the outcome of constraint – but it remains to be seen whether as the economy improves they will be able to access their tenure of choice. Evidence on behaviour in the next few years will strongly influence new supply.

## **A2.2 Key findings from the workshop on the German rental market held at the Institut der Deutschen Wirtschaft, Cologne on 19 March 2014**

The purpose of the workshop was to hear presentations from experts in the private rental market in Germany. There were three key questions:

- What are the conditions for a well operating private rented sector?
- What is necessary for new investment in the sector?
- What type of housing investment? New build, whole buildings? We need to add to total supply to expand the sector significantly.

At the half day workshop experts had been invited to present findings and experiences of the German rental market. There were three presentations followed by discussion.

### **1. Why is there such a low home ownership rate in Germany?**

Compared with the USA and France, home ownership is low in Germany. Traditional explanations for the low home ownership rate include

- socio-economic and demographic factors – but these do not account for the gap before the 1980s.
- a trade-off between public welfare and home ownership – but prior to 1980 welfare increased at the same rate as home ownership
- government subsidies favoured public and private rental construction in post WW2 – but in fact subsidies existed before WW2
- cultural explanations: Germans prefer renting – but surveys show a preference for home ownership of over 50% and up to 80%
- ideological and political explanations

None of these is satisfactory. An alternative explanation is based on the idea that what was built in the past determines the tenure split in the present. A comparison between the USA and Germany shows that the percentage of single family dwellings (houses) built in Germany in the 19<sup>th</sup> century was low – flats were built in Germany and houses in the USA.

However, in southern European countries high numbers of apartments were also built, yet home ownership rates are much higher than in Germany. This can be explained by the legal system. German law did not allow individual ownership of parts of a building until the 1980s, and even then it did not occur to the same extent as in the UK and France.

A further explanation for the difference is that the production of single family homes in Germany is mainly self-build, which was initially very limited, and today the high quality of new build single family dwellings means that they are very expensive. In the USA, Fordist mass production methods were used to build houses, whereas in Germany economies of scale were associated with building apartment blocks for rent.

In addition, in Germany in the 19<sup>th</sup> century employers in the larger cities built the housing, so there was no perceived need to buy.

There were also difficulties in financing home ownership in the 19<sup>th</sup> and 20<sup>th</sup> centuries. In Germany, mortgage banks were set up in the 1880s and housing associations in 1924 (earlier ones failed).

The overall explanation requires critical junctures. Ordinary least squares regression shows the legacy of pre-1918 tenements with an R-squared of 0.72.

In conclusion, national housing policies were unable to reverse the outcome of the critical juncture. However, emerging trends that would enable the individual ownership of apartments and further suburbanisation of new building could change this.

## **2. Why is there such limited new build for single family homes?**

The German government wanted to encourage home ownership and as part of this policy state owned companies were established specifically to build single family homes for owner-occupation. But the perception is that because the number of households is declining in Germany, there is no overall shortage of housing supply. There are regional imbalances, however, and housing shortages in certain large cities.

Overall demand is lower than in other countries. For example, German households move home on average only 2.3 times in a lifetime. This contrasts with the Dutch who move 6.7 times, driven by the tax system, and the UK where households 'trade up' every 7-10 years driven by rising capital values (the 'housing ladder').

According to a survey due to be published in June, the French build 5.6 new homes per thousand population; in the Netherlands this is just 2 homes per thousand, and in Germany 2.7 per thousand

## **3. The German residential investment market**

There is limited research on residential investment. Companies undertake their own internal research on real estate diversification but academic output has been very limited until recently. The lack of institutional investment is perceived to be linked to regulation and politics. Many investors get their returns indirectly through a fund, not by direct investment or asset purchase,

There are three main reasons why institutions invest in residential property.

1. Stability of cash flow. This protects the investment in both inflationary and deflationary environments.
2. The private rented sector is perceived as a bond surrogate especially in Germany, Denmark, and Finland.
3. An optimal portfolio should contain a mix of investments with different levels of risk and there is a role for residential to provide a long term income stream.

This is why there is so much recent interest. Germany has the largest private rented sector, followed by Denmark, France, and Belgium.

However, regulation is perceived to affect the performance of the investment. There is talk about increasing regulation in Germany. New build is exempt but only for the first stage. How long is it new? But the talk leads to insecurity and fears of lack of future stability of the sector. It is also perceived that privatisation of social rental units is not a good business model.

There are three main types of investors in the German residential investment market:

- the core – who buy and hold their investments in the long term
- those who want to add value– who invest in under-rented assets
- opportunists – who look for development prospects, particularly in rural areas

Germany is multi-centred with lots of large cities and no single city dominates – unlike London in the UK. There has been a nominal price rise of 20% over the last 10 years –this is very high even after taking account of inflation.

In Germany there are 40m rental units (population 90m) and institutions only own 10-15% of them. Private individuals still dominate. The top locations are heterogeneous but the federal structure of government enables a stable market overall. This is especially true for the seven largest cities.

Berlin has the most institutional investment – housing associations, other institutions, companies. There is a lot of trading going on – blocks, portfolios. Yet Berlin is not the headquarters of the larger companies (none of the top 30 are there).

The top six residential markets are very diverse. There is a mismatch between completions and population. In the past government policy was to increase home ownership. A cynical view is that if they regulate rents, it might increase ownership – but it might reduce quality in the PRS.

There is a secure stable cash flow to be earned from property let to low income households who are virtually guaranteed by the state.

## **Discussion**

In Copenhagen, Denmark tenants must pay 6 months rent up front (deposit plus rental). If it is new build, they pay a market rent – called the ‘agreed rent’ (but it can be disputed later). If the tenant does not sign a contract with the agreed rent, it reverts to the pre-1991 legislation with full rent regulation.

In the UK, in one of the new developments more than 50% of tenants did not choose a 5 year contract over a 6 month assured shorthold tenancy even though the rent was indexed and termination rules were identical.

The German experience shows that it needs a lot of time to develop a stable properly operating rental market – but it also shows that the scale matters for the nature of the product. In the German market many tenant households have adequate secure incomes and pensions. This group would be in owner-occupation in the other countries. Equally the nature of the product is often more like an owner-occupied home in that tenants are responsible for white goods and often kitchens and bathrooms. Thus the product evolves in relation to which

consumers are involved and it is not possible to make simple like to like comparisons between different systems and different histories.

### **A2.3 Key findings from the expert meetings on the private rental sector in The Netherlands held at TU Delft on 16 April 2014**

The purpose of the two expert meetings was to discuss the investment climate for private rental dwellings in the Netherlands, and to identify the opportunities and barriers that existed in the past decades, after the Global Financial Crisis (GFC), and after the recent and planned policy changes. Participants were invited based on their expertise in the investment and management of private rented property in the Netherlands. They included representatives from investment fund managers and developers as well as landlords, investors and real estate entrepreneurs operating in the Netherlands and elsewhere in Europe.

#### **Morning expert meeting: key points discussed**

- The representatives from the investment funds explain that there has been structural investment in the rental market in the Netherlands which has increased the end of 2012 . One of the interviewees adds in July of 2014 that in the first half of 2014 1.1 billion Euro have gone into residential investment in the Netherlands. This implies a +83% increase in comparison to the first half of 2013.
- The investment portfolio will often be mixed according to rent level, geography and also type of dwelling (single-family and multi-family rental units)

#### **Rent levels**

- There is a growing demand for the units with a deregulated (also called liberalised) rent: properties with rents from €700-€1000 per month in the cities of Brabant and the Randstad (a Rim City consisting of Amsterdam, Utrecht, Rotterdam and the Hague, including suburbs)
- The upper limit of the range differs according to region, and may reach €1200 in the northern part of the Randstad, up to €1100 in the southern part of the Randstad, and up to €1000 in the cities of Brabant; and generally much lower elsewhere
- Because of the crisis unsold owner-occupied dwellings are also on the market for €1100 plus. It is therefore very competitive
- Service charges are regulated. Landlords seem to charge fairly low service charges, although it depends on the location and the nature of the building complex. However, there is a surplus of rental income, accumulating as savings which can cover the repair and maintenance costs

#### **Increasing demand for renting?**

- There has been a shift in the customer mindset. Before the crisis, buying an owner-occupied dwelling was all important. But according to the last survey in Brabant conducted by an investment fund, more younger people are opting for a rental home. This also applies to the 55+ age group who want to move, but do not do so (yet). As the proportion of single person households is growing, including the share of the elderly, average household incomes are falling, people want to rent. Single person households are particularly attracted to private renting because of lower incomes. Elderly households

prefer to rent because they are not responsible for the repair and maintenance problems of the dwellings. Renting allows people to be mobile and, for former owners, to release equity from the home

- The Brabant city study, however, shows that people would still like to own a single-family home, but it is difficult to get a mortgage loan and greater mobility is required in the labour market. The perception of the risks associated with owner-occupation is thus much higher than it used to be. Also the idea of owning has become less important; use seems to have become more important (structural?). As a result it is difficult for middle-income groups to find housing
- Furthermore, the higher the rent, the more competitive owner-occupation becomes. With falling house prices, some tenants are now considering buying. This is pushing the vacancy costs up for investments in the higher-rent segments in contrast to an investment in a lower-rent property where tenants have long tenancies. 35 years is no exception<sup>16</sup>
- At the lower end of the rental market, the direct returns are comparable to those at the higher end (the units with a deregulated or liberalised rent) because there are no vacancies and a low turnover rate
- In the non-profit rental sector rents are rising, but many people cannot afford higher rents; therefore in the regulated sector, private landlords are willing (or forced) to keep rents below the liberalised rent level to ensure a stable tenancy in the longer term. In practice, in areas (like Oost-Groningen and Zuid-Limburg) with low pressure on the housing market, housing associations are demolishing units to keep the vacancy rate down

### **Level playing field?**

- There is no level playing field, as long as tax deductibility for mortgage interest payments has not disappeared completely. The position of the units with the deregulated rent in the PRS has improved because of the limitation of tax deductibility of homeowners. Also the income-related rent increases in the regulated rental sector (see below) have helped to make the deregulated rental units a more attractive choice
- The PRS may continue to grow in the growth areas; however new investment is only likely in very good locations
- International investors are in principle only interested in Amsterdam until they find out about the land lease system which then may deter them. There are some examples of stock acquisition by international investors throughout the Netherlands
- There are no suitable investor vehicles to spread risk. The FBIs (a type of REIT) that are more often used nowadays do not need to pay tax, as long as all profits go to shareholders
- It is not easy to convert regulated rental units to deregulated units. It is the number of 'quality points' which decides which rents of rental stock can be deregulated. The conversion of regulated rental stock to apartments with a deregulated rent requires substantial renovation and/or expansion of the dwelling in order for the unit to be classified as part of the deregulated private rental market. As an example, two months' rent is required to finance the insulation of a dwelling to achieve the required standard
- Another complication in certain municipalities is the ability to split apartment buildings into independent apartments (condominium rights)

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<sup>16</sup> The Global Financial Crisis has prolonged tenancies as people do not want to move. Before the crisis, owner-occupiers moved every 10 years and renters moved every seven years

## Other barriers to new investment

The main issue faced in the regulated rental sector is the **landlord levy**<sup>17</sup> which was introduced last year (2013). It is expected to have an enormous effect on the regulated PRS. It was estimated that the levy may cost up to two months' rent by 2017. For box 3 tax payers in personal income tax in particular, it was estimated that 30% to 40% of their return will be taken up by income tax and the landlord levy.

The compensating income-linked rent increases that were introduced in 2013 for two years in order to generate more revenue for landlords are not considered adequate by the sector. Increasing costs mean that new investment by private investors will not be stimulated in the regulated sector. If there is any new investment, it is likely to be in the deregulated sector, but even there competition is strong because of affordability problems (or unwillingness to pay high rents in the present system) for tenants and extra supply from unsold owner-occupied homes and other sources of rental housing supply.

Is it a good time to invest? Prices have gone down and it is seen as a good time for institutions to rejuvenate their portfolios, as actual investments show (see above). The policy changes in favour of deregulated private renting are considered positive.

However, the current political instability (i.e., the frequent policy changes and the temporariness of regulations) was mentioned as possibly discouraging investment in private renting: the income-linked rent increases are for two years; the landlord levy tariffs are determined until 2017; there are further plans to change the system of rent control. The problem is not knowing what government policy will be in five years' time. Furthermore, investors are looking for opportunities, but many prefer immediate cash flows in more liquid investment situations. Buying stock from housing associations was not regarded as very popular. The expectation is that the relatively short payback period for private renting in the Netherlands of 22 years (for Germany, 25 years) will increase. The present gross yield of 6-7% is considered quite high.

## Conclusions

Because of the uncertainty in the policy environment and the illiquidity of property investment, the deregulated rental sector may not be considered as a good investment environment, although the policy movement towards 'more market' is a move towards better attractiveness of investments in the deregulated rental sector. Political uncertainty is also relevant for the regulated rental sector which at the same time faces much higher taxation than in the past.

## Afternoon expert meeting: key points discussed:

- The majority of the rental portfolios of the experts present are in the regulated sector
- The deregulated sector is a thin market. It faces keen competition from owner-occupation
- Rent levels for existing tenancies are under negotiation. Because existing rents are lower than new rents, tenants prefer not to move at all (prolonged tenancies; see above)

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<sup>17</sup> The Landlord Levy (*verhuurderheffing*) was introduced in the Budget 2013. This tax is levied upon the ownership of houses in the regulated housing market. The levy is calculated upon the aggregate ('WOZ') value of the houses. An exemption exists for the value of the first 10 houses of each owner. For 2013, the tariff was 0.0014% (<http://www.rijksoverheid.nl/documenten-en-publicaties/circulaires/2013/07/09/informatieblad-verhuurderheffing-2013.html>). Up until 2017 the rate will increase in 2014 to 0.381%, 0.449% in 2015, 0.491% in 2016 and 0.536% in 2017 (<http://www.rijksoverheid.nl/onderwerpen/huurwoning/verhuurderheffing>).

- The incentive to stay has increased. This is also reflected in increased applications for co-tenancies; especially in cases where Donner (scarcity) points would put the rent above the €700 limit for a new tenant. Co-tenancy allows rents to remain at the same level
- Also, income-related rent increases will not hold for very long, as people move out. It is observed that tenants leave because they cannot pay their rent. Income-related rent increases only work in attractive areas. One question was whether if the two-year income related rent increase were larger, it would be enough to bridge the gap. It was felt that it would not, because private investors cannot increase rents, the maximum rent of almost €700 (2014) is the limit
- The major impact of the landlord levy, together with the points system, is squeezing the size of the regulated sector, which will push the regulated units to deregulated renting, if possible. This switch to the more expensive segment will create a bubble, as the market is very thin (see above)
- Selling a regulated rental unit with a sitting tenant will not solve the problem, as tenant security is permanent and house prices are lower with rent controls than without them
- Source of finance: 50-60% comes from the capital market, there are three or four banks that provide loans to buy properties for renting. The bond market is too expensive and the government does not see a need to provide a loan guarantee for private renting
- It is possible to earn a reasonable return on the properties that were in ownership for more than 10 years including the last two years. The direct return will be 2.5%, while the IPD return generally is 4%, except for this year because of a higher depreciation. Profits are not usually made from renting, but from buying with a sitting tenant and selling with vacant possession
- The Landlord Levy has put private investors in an unviable position. It is very high and comes directly out of profits, making renting less profitable
- The original idea of the landlord levy was that housing associations would pay back some of their equity, but now it also applies to the regulated PRS. Professional landlords are proposing two regulatory systems, one for social renting and one for private renting. The minister does not seem to be open to this suggestion
- The costs of letting are also increasing because of changing attitudes among tenants. They used to do a lot of maintenance themselves, but they no longer do so and instead are demanding more services
- The tenant lobby group is politically strong; tenants are not used to paying higher rents. In the future there will no longer be any margin, when energy costs will amount to half of housing costs. Furthermore, there is a cultural perception that people have the right to have cheap affordable housing. The only way to increase the rent is to carry out improvement work on energy efficiency because there is a taxation relief on energy work. An extra tax on households that pay too little rent in relation to income might work
- If the points system was shifted towards a property value approach (using the WOZ-value) as is the aim of the ministry, renters will be stakeholders in the value determination process (appraisal). The WOZ-value will not be fixed in relation to either the market value with vacant possession or the condominium value for an independent unit
- The new government proposals aim for short-term contracts for new tenants for 2-3 years in certain situations. In general that would be desirable, but not in city centres. Short term temporary leases may have a positive impact on the PRS. It may improve the quality of the stock as it will induce competition. At the moment, there is not much renovation work because tenants do not move and renovation generally takes place only with vacant possession

## **Main problems:**

For private companies, the rental market is not a *level playing field* because:

1. unlike housing associations, they cannot access low interest government backed guarantees for investment
2. housing associations give extra discounts when selling their units to existing tenants and they offer a buyback guarantee for instance. One of the experts tried to offer a buyback guarantee but discovered that banks value the guarantees differently
3. housing associations provide low interest loans to homebuyers

## **From a regulation point of view**

1. The yield is too low which discourages large overseas investors. There is some new construction for private renting, but it is too expensive to buy at this moment. This is purely a yield problem. Higher yields are possible from investment in housing association stock
2. The LTVs remain quite low when considering 50-55% leverage
3. The GFC had several effects. House prices have fallen; debt finance has become more difficult. Unwinding will take longer than 10-15 years. There needs to be capital behind investment. One positive outcome of the crisis, however, is that it caused a shake-out and only professionals remain. The realization of new investments will take time because of procedures. There will be little actually built in the short term (2 years) after the crisis
4. Profitability in the sector has declined because of the changed Box 3 taxation which applies to private investors (professionals in box 1 or corporate tax). The value to be taxed used to be negotiated with the tax officer. In the last couple of years it has become a percentage of the WOZ-value, which increased the tax burden (see above). The amount of tax charged is not related to the invested value

## **What experts would want government to change:**

1. Abolish the Landlord Levy (for private investors)
2. Reduce security of tenure (also only for private investors; tenants needing protection can rent from housing associations)
3. Lower the 700 Euro limit (rather than a freeze of three years, as is currently proposed)
4. A different set of regulations for private and social landlords
5. Abolish the Living Permit System in Amsterdam which restricts international migrants to renting units in the deregulated PRS segment of the market

## **Conclusions**

The Netherlands do not (yet) provide an attractive environment for investors in private renting in the regulated rental sector, despite the growing demand for private renting. The major concern is the imposition of the Landlord Levy and changes in regulations and in personal income tax to the disadvantage of the private investors in the regulated rental sector.



## **A2.4 Conclusions from the workshops: international comparisons**

It is always difficult to make international comparisons but the workshops together confirm that there are many similarities facing the private rented sector in the different countries. The barriers to new investment are virtually the same: risk, perceptions and the difficulties in obtaining a balanced portfolio that accommodates the range of risks across different markets. It also seems that in all countries the PRS is increasingly being used to house low income households with the aid of housing allowances, and landlords in this market can earn a secure stable cash flow that is supported by the state over the long term.

However, there are important differences between the countries examined.

In Germany, with the largest PRS, private rented property is perceived as a good investment because rent regulation and security of tenure mean that it can provide a stable cash flow over the long term. It is seen as a surrogate for investment in bonds, and because a balanced portfolio should include a mix of investments with different risk levels, residential property is attractive in providing some of those different attributes. However, the PRS market differs across the country and the six largest rental markets are very diverse.

The taxation system in each country is different. In England the government is beginning to understand the need to encourage investment, although REITs have not been as successful as they had hoped. In Germany, while the private rented sector has been extremely stable in the past, excess demand is forcing up prices in many cities and recent talk of increasing regulation has raised doubts about its future stability as investors perceive regulation as harming the performance of the investment. In the Netherlands, the main difference is not between social and private renting, but between the regulated and deregulated sectors. Although the private rented sector as such is quite small, demand has been increasing recently because of the limitation of the favourable tax treatment for home ownership, the income-related rent increases in the social rented sector and the impact of the GFC. At the top end of the market, unregulated rents may make owner occupation more attractive, but at the bottom end there is competition from social renting. The tax situation of landlords who own dwellings with a regulated rent has worsened recently with the introduction of a landlord levy on the regulated sector.

The discussions concentrate heavily on investment aspects, reflecting the current environment where governments are looking to replace their own involvement with long term often equity private funding. There is currently a great deal of interest and discussion – but there are few new private rental specific investments actually in place. This suggests that there may be more fundamental issues about the nature of the private rented product as compared to that available in owner-occupation and owner-occupation which help determine consumer choice and investor potential rather than, as it often seen to be the case, it being purely a matter of tax and subsidy.

## Annex A3: Literature review on user costs

The objective of the user cost approach is to estimate the cost of using the shelter services. It is basically a *financial opportunity cost* (or the estimated cost) of using the services of the dwelling unit during the period under consideration (Woolford, 2010).

### A3.1 User cost of owner occupation

In housing literature, the user cost (or the annual cost) of homeownership is also known as the ‘imputed rent’”

#### *US literature*

In the United States, various economic models have been employed to explain the performance of the market for owner-occupied housing. The most cited author is Poterba’s (1984) analysis of the effects on the tax deductibility of mortgage interest on the American housing market.

A recent example of user cost of home owning was constructed by Himmelberg et al. (2005). Their user cost aimed to evaluate the cost of home owning and they applied it to 25 years of history across a wide variety of housing markets in the United States. It was the sum of six components representing both costs and offsetting benefits (see also Poterba, 1991):

1. the real interest rate — namely, the interest cost, less expected appreciation on the dwelling and land;
2. the one-year cost of property taxes;
3. an offsetting benefit to owning, namely, the tax deductibility of mortgage interest;
4. maintenance costs;
5. the expected capital gain (or loss) during the year; and
6. an additional risk premium to compensate homeowners for the higher risk of owning versus renting

They found that the real interest rate was the key determinant of the user cost of housing. A lower real interest rate reduced the user cost because the cost of debt financing was lower, as was the opportunity cost of investing equity in a house. Given that mortgage interest was tax deductible in the USA, when the real interest rate was low, homeownership was particularly attractive because mortgage payments were low and alternative investments did not yield much. However, their model was derived for a cash purchaser, which did not include the direct cost of a mortgage. Also, they argued that there was a higher risk of owning relative to renting.

Under classical (frictionless) assumptions, with perfect competition in the rental market, rents equal ex-ante user costs. However, Garner and Verbrugge (2007) studied the relationship between rents and user costs in the five largest cities in the United States. Using Consumer Expenditure Survey interview data between 1982 and 2002 (4,952 interviews), they found that it is not always cheaper to own. For the median structure in each city, estimated user costs and rents diverged, and user costs sometimes lay above rents. This was because rents steadily and smoothly increased over the period. In contrast, user costs rose rapidly, driven by rising interest rates and falling expected appreciation rates. The rise in user cost between 1987 and 1990 resulted primarily from a decline in expected home price appreciation. Since 1981, despite rising home prices, user costs displayed no upward trend at all: the steady upward trend in home prices was effectively ‘cancelled out’ by a reduction (over this period)

in the gap between the mortgage interest rate and the expected home price appreciation. Thus, the relative price of homeownership to renting fell substantially over the period.

Díaz and Luengo-Prado (2011) estimated the user cost of owner-occupied housing using US data from 1995 to the beginning of the subprime crisis. They defined the cost of owner-occupied housing services as measured by the user cost of housing and found that it depended not only on house prices but on the preferential tax treatment of owner-occupied housing services, the availability of collateralised credit, the insurance role of owner-occupied housing against rental-price risk, as well as current and expected transaction costs. They found that the user cost of owner-occupied housing defined in this way did not increase during the years of the price upsurge.

Sinai and Souleles (2005) point out that the potentially important benefit to homeownership is the hedge that it provides against the risk of fluctuations in future rent payments. Home owning provides a predictable way of paying for housing services. With renting, the future cost of obtaining housing services is uncertain. On the other hand, homeowners face asset price risk while renters do not. Thus, while homeownership provides a hedge against rent risk, its value is tempered by the associated asset price risk.

#### *European literature*

Elsinga (1996) compared relative cost of owner-occupation and renting in six Dutch neighbourhoods. She identified the following key components which influenced housing costs in the Netherlands.

**Table A3.1 Factors affecting the user cost among owner-occupiers and renters in the Netherlands**

	<b>Market</b>		<b>Government policy</b>
Owner-occupied	amount	interest, value of dwelling	property subsidies, fiscal policy, land policy
	development	interest: fixed interest term, time of transfer value: important at time of purchase and sale	no direct influence
	distribution	no direct influence	fiscal treatment of home ownership: de-leveling effect, property subsidy: levelling effect
Rented	amount	rent (amount of development cost determines initial rent)	property subsidies: housing allowance, maximum reasonable rent for dwellings under allocation rules, land policy
	development	market effect becomes more important: increased differentiation opportunities for the landlord	previously: trend rent now: minimum and maximum rent increase
	distribution	no direct influence	housing allowance: leveling effect

Source: Elsinga (1996) Table 1.

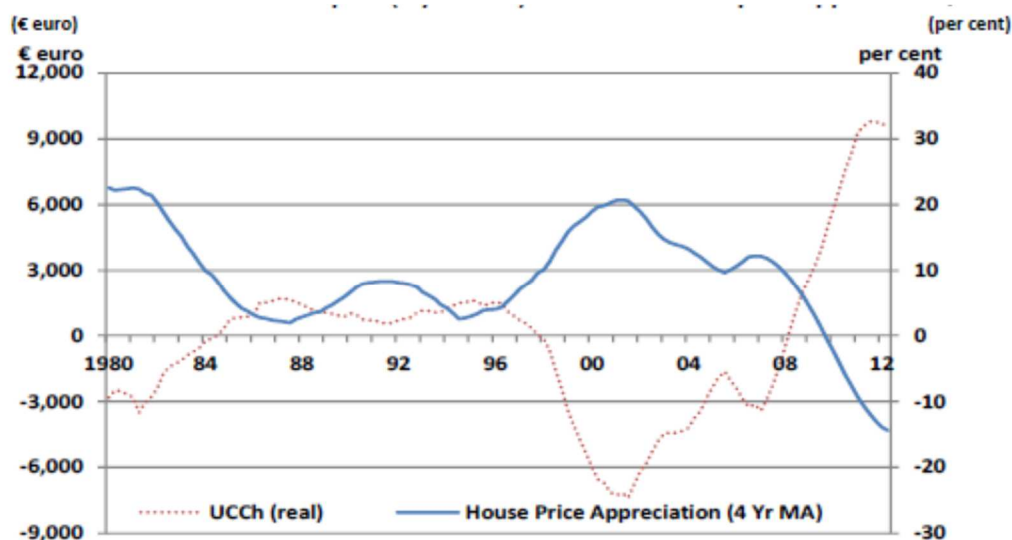
For owner-occupation, the first component of user cost is the cost of assets invested in the dwelling. This consists of mortgage interest and the opportunity costs of the equity

investment. The second component includes the costs of management – covering items such as insurance on the building, transaction costs, and real estate tax – and maintenance. And finally, the change in value of the dwelling has to be brought into the equation. First of all, this change may reflect a price increase due to inflation. Secondly, it may reflect depreciation and/or any improvements that may have been made on the dwelling.

In her research, the user costs were calculated ex post. The results were from a survey conducted in 1993 among 540 owner-occupiers and 400 renters in six different neighbourhoods. Elsinga interviewed households about the purchase price of their housing, which allowed her to set up a sort of price index, as the owners had bought their houses at different dates. The change in that index is a central component in her annual user cost of owner-occupied housing; so much so that it dominates the comparison in user costs. During the first half of the 1980s, when house prices were stable, the user cost of owner-occupied housing was higher than that of rental housing. The strong rise in house prices during the second half of the 1980s reversed the comparison. The mortgage interest rate also plays an important role in the comparison, as it seems to affect only the user cost of owner-occupied housing. Indeed, a surprising result of Elsinga's (1996) research is that rents do not reflect changes in interest rates and property prices: they grow perfectly in the Netherlands. She thus showed that homeowners are exposed to considerable risks, risks that landlords seem to absorb completely when they set rents. As a result, homeownership, just like common stocks, is an asset that can only be recommended to investors who calculate their returns over a very long horizon – or who do not care about true costs. Nevertheless, Elsinga's research illustrates the volatility of empirical user costs. It may be more advantageous to own one's home in a certain year, when real estate prices grow and interest rates are low, and less advantageous the next year, when prices decline and interest rates rise.

Browne et al. (2013) uses the user cost of capital to examine Irish house price movements. Their user cost concept takes into account a number of factors, other than just the direct and opportunity costs of house purchase, that impact on the cost of the bundle of services conferred by homeownership. Primarily, these comprise taxes and subsidies along with the expenses incurred for depreciation and maintenance. Their user cost calculation is based on a married couple with two children who are first-time buyers. They found that between 2002 and 2007, a combination of factors including rapid house price appreciation and the prevailing fiscal and monetary environment created a strong bias towards homeownership. This was reflected in a negative user cost of housing as capital gains exceeded funding costs (both direct mortgage cost and the opportunity cost) thereby incentivising home ownership and fuelling further increases in prices. They also found that the collapse in house prices since 2007 has contributed to a reversal of this process. From mid-2007 onwards, the user cost has soared as capital losses have greatly exceeded the funding costs (albeit falling) causing house prices to fall further.

**Figure A3.1 Real user cost of capital (UCCh) and actual house price appreciation in Ireland, 1980–2012**

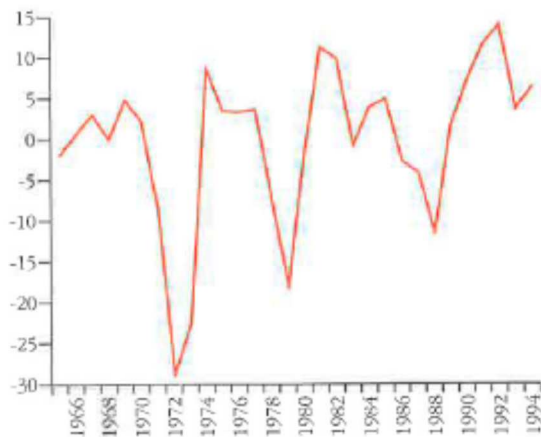


Source: Browne et al., (2013) Chart F.

#### *UK literature*

Earley (1995) looked at the user cost of housing in the UK over the period 1966-1994. The user cost is calculated by assessing the cost of borrowing, the interest foregone on savings, plus the cost of repairs and maintenance, service charges and so on plus any depreciation and any expected changes in house prices using actual change as a proxy. The chart below shows clearly that movements in the user cost of housing are affected most of all by house price changes and by interest rates (Earley, 1995). In the late 1980s, very high house price inflation pushed down the user cost. The higher loan to value ratios allowed by lenders in the mid 1980s coupled with the relatively low levels of interest rates also meant that the cost of financing house purchase was low. The user cost of housing increased most sharply between 1989 and 1992 as a result of increased interest rates prior to sterling's departure from the European Exchange Rate Mechanism (ERM). Falling house prices added to this, and while interest rates fell back, prices continued to fall. Finally, the reduction in mortgage interest tax relief further ensured that the costs of owner-occupation remained high relative to the 1980s.

**Figure A3.2 User cost of owning a house in the UK, 1966–1994**



Source: Earley (1995) Chart 6

To assess the effects of stamp duty on the cost of homeownership, Andrew et al. (2003) calculate the user cost of owner-occupied housing which comprises:

- the mortgage interest rate paid by the home-owner
- the interest rate on a “typical” asset held by households
- the price of the house
- the extent of debt gearing as opposed to equity finance
- any tax relief available
- expected capital gains on the house
- local taxes, such as the Council Tax
- maintenance expenditures on the property
- Stamp duty and other transaction costs
- depreciation

**Table A3.2 User cost calculations, based on 2001 figures**

	<b>North</b>	<b>Greater London</b>
Mortgage interest rate (%)	6.0	6.0
National savings rate (%)	4.5	4.5
House prices (£)	70,550	181,750
Loan to value ratio (%)	70	70
Rate of mortgage tax relief (%)	0	0
Local Council Tax rate (%)	1.0	0.5
Maintenance expenditures (%)	1.0	1.0
Depreciation rate (%)	1.0	1.0
Stamp duty rate on average house price (%)	1.0	1.0
User cost of capital (assuming 8% expected gain)	1,093	1,908

Source: Andrew et al., (2003) Table 7.

Andrew et al (2003) compared the user cost of housing in Greater London with the north of England. The table below shows that calculations of the user cost depend crucially on the expected capital gain. Andrew et al. (2003) assume a capital gain of eight per cent. At these values, the user cost in London is a mere £1,908 pa and, in the North, £1,093. This explains

why owner-occupation is popular. By contrast, if house prices be expected to fall in London, then the user cost rises dramatically, because there is no longer an equity gain. For example, if prices fall by, say, 10 per cent, then the annual user cost rises to a staggering £35,532.

The Cambridge Centre for Housing and Planning Research (CCHPR) undertook two studies to compare housing association (HA) rents, local authority (LA) rents, private sector rents and owner-occupation (OO) user costs at different spatial levels (i.e. national, regional and local authority levels) and for different property types. The first study looked at two years, 2005/06 and 2001/02 (Whitehead and Cao, 2007). The OO user costs were measured by calculating the weekly cost of repaying an average loan on a lower quartile house price together with estimates of the cost of building insurance, mortgage payment protection insurance and the imputed loss of interest on the deposit. Their key findings were:

- In 2001/02, the national ratio between OO costs and HA net rents, 57 per cent, was very close to the ratio between private rents and HA gross rents, 47 per cent (note that the first uses HA net rents while the second uses HA gross rents including service charges eligible for Housing Benefit). However, by 2005/06, the difference between OO costs and HA net rents had risen to 170 per cent, as against 68 per cent for private rents.
- The differences between OO costs and HA net rents in 2001/02 were smaller than the differences between private rents and HA gross rents in three regions: the North East, the North West, and Yorkshire and the Humber. But by 2005/06, the difference between OO costs and HA net rents in the North East was more than 100 per cent; in London, where the biggest differences were found, the ratio rose from 153 per cent in 2001/02 to 257 per cent in 2005/06.
- Generally, the pattern of differences between OO costs and HA net rents is market driven – with the smallest difference found in LA areas in northern regions, particularly in low demand areas of the North West. The largest increase in the differences was found in the highest demand regions, notably London.

The second study looked at the period from 1998/99 to 2006/07 (Udagawa and Tang, 2008). It found that OO user costs at the lower end of property market in England increased rapidly in this period. This was particularly apparent in the second half of the period when house prices soared after the tightening monetary policy was introduced to cool down an overheated property market. The high increase in OO costs implies that differentials between OO costs and HA rents expanded over the nine-year period, so that by 2006/07, OO costs were more than double HA rents in all regions.

### **A3.2 User cost of private renting**

User cost is less frequently employed in analyses of rented housing and indeed, some of the user-cost literature is almost silent on the subject of renting. Even so, there are some attempts to extend the user-cost analysis to rental tenure.

#### *Private landlords*

To uncover the factors that influence Australian's landlords' decision to retain their rental investment, Wood and Ong (2013) define the landlord's user cost as the investor's costs (maintenance, interest payments, the opportunity cost of equity capital and so on) of holding an asset for one year, net of the capital appreciation accrued over the course of that year, and after taking into account the tax treatment of net rental income, capital gains, land and transaction taxes. The user cost of landlords also includes damage costs, vacancy and default

on rent costs, billing costs, and if applicable, tax advantages of homeownership (Heston, 2009).

#### *Private tenants*

For private tenants, the cost of the consumption of housing services is equal to the expenditure that the renters have to make. Thus, user cost is the same as housing expenditure. Accordingly, user cost covers the following items: rent, service charges, and housing allowance (Elsinga, 1996; Thalmann, 2007).

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# Under- standing the Role of Private Renting

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ISBN: 978-87-93360-05-1