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CAPITAL ECONOMICS

BUILDING NEW SOCIAL RENT HOMES

AN UPDATED ECONOMIC APPRAISAL

The economic case for building 100,000 new social rent homes a year in the light of Brexit

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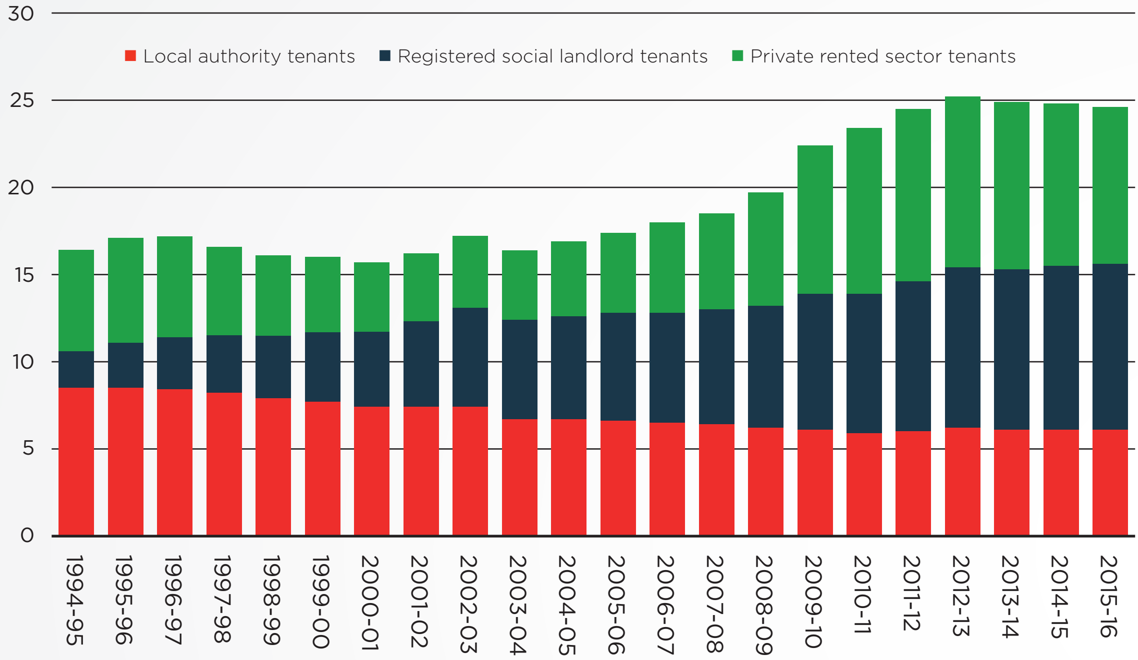
ECONOMIC CASE FOR BUILDING NEW SOCIAL RENT HOMES

Figure 1: Real government expenditure on housing benefit in the United Kingdom (£ billions, 2016-17 prices)



Sources: Capital Economics and Department for Work and Pensions, *Budget 2016 Expenditure and Caseload forecasts* (Department for Work and Pensions, London), 2016.

There is broad agreement that not enough homes are being built each year in Britain to keep pace with rising demand. The planning system is often blamed, but the reality is more complicated with further issues including land availability and financing problems.

The misalignment of supply and demand is causing housing costs to become increasingly unaffordable for individuals and families across all tenures. In this context, housing at rents which are genuinely affordable has an important role in ensuring accommodation for those who might otherwise be priced out of the market. The shortage of such homes has pushed tenants into the private rented sector and increased the housing benefit bill. (See Figure 1.)

There is room for improvement in existing policy. The current allocation of public expenditure to housing does not take into account the future costs to the welfare system of meeting higher rents in the private rented sector and 'affordable rent' social housing.

We published research last year showing that the government would achieve better value for taxpayers' money, as well as improve the living standards of many low-income households, if it were to part fund the delivery of 100,000 new social rent homes each year rather than continue with its existing policy.[1] The economic context has changed since then, not least because of Brexit, and in this report we assess how a different economic future affects our conclusion.

[1] Capital Economics, *Building new social rent homes* (Capital Economics, London), 2015.

WHAT WILL THE ECONOMY LOOK LIKE AFTER BREXIT?

Figure 2: Economic scenarios

	Weak economic growth	Strong economic growth
Low borrowing costs	**Britain becomes Japan** • Article 50 triggered in 2016-17 and Britain leaves the EU in 2019-20 • Decline in business investments leads to modest recession in 2019-20 • Economic weakness keeps inflation low • Low policy rates and sustained economic weakness keep borrowing costs low • New trade deals start in 2031-32 and growth picks up	**Productivity boom** • Article 50 triggered in 2016-17 and Britain leaves the EU in 2019-20 • Quick negotiation of new trade deals strengthens business and consumer confidence, leading to robust economic growth • Sufficient spare capacity and a productivity boom keeps inflation at target. Policy rates and borrowing costs rise at a slower rate than 'capacity constraints' scenario
High borrowing costs	**Back to the 1970s** • Article 50 triggered in 2016-17 and Britain leaves the EU in 2019-20 • Decline in business investments leads to modest recession in 2019-20 • Inflationary surge caused by falling exchange rate • Policy rates rise to contain inflation, borrowing costs increase • New trade deals start in 2031-32 and growth picks up	**Capacity constraints** • Article 50 triggered in 2016-17 and Britain leaves the EU in 2019-20 • Quick negotiation of new trade deals strengthens business and consumer confidence, leading to robust economic growth • Lack of spare capacity pushes inflation higher, forcing up policy rates and borrowing costs

Source: Capital Economics.

The future state of the economy will affect how much the government would be able to save by housing more families in social rent homes. With so much uncertainty surrounding the United Kingdom's future relationship with the European Union, it is impossible to say credibly that we know what the British economy will be like after Brexit. We can though paint a broad picture of what 'good' or 'bad' outcomes might look like.

We consider four possible scenarios for the British economy and assess how each affects the net fiscal impact of building 100,000 new social rent homes each year. These scenarios are differentiated by whether there is weak or strong economic growth after Brexit, and whether the government's cost of borrowing is low or high. (See Figure 2.)

A 'good' Brexit outcome could occur if the United Kingdom is quick to negotiate new free trade deals with fast-growing economies around the world and the European Union. Robust economic growth would support a rise in interest rates. The extent to which borrowing costs would rise is dependent on the scale of spare capacity in the economy. A 'productivity boom' would help to contain inflation and keep interest rates lower for longer; 'capacity constraints' would create inflationary pressures and increase borrowing costs.

A failure to negotiate favourable new trading relationships could create a 'bad' outcome if consumer and business confidence is severely damaged and investment curtailed. This could push the economy into a prolonged state of weakness. This could see 'Britain become Japan' and face a lengthy period of low growth, inflation and interest rates. Alternatively we could see a shift 'back to the 1970s', with low growth accompanied by a falling exchange rate, high inflation and rising borrowing costs.

IMPLICATIONS FOR PUBLIC FINANCES

Figure 3: Impact on annual general government net borrowing as a percentage of nominal gross domestic product

Source: Capital Economics. Note: this includes borrowing by local authorities and Arms' Length Management Organisations.

The results from our analysis are clear: the government would still achieve better value for taxpayers' money, even under these stretched economic scenarios, if it were to part fund the delivery of 100,000 new social rent homes each year. This is consistent across our economic scenarios. (See Figure 3.)

In the initial years, the incremental welfare savings and new tax receipts will be less than that needed to fund the government's contribution to the new homes – so additional borrowing will be required.

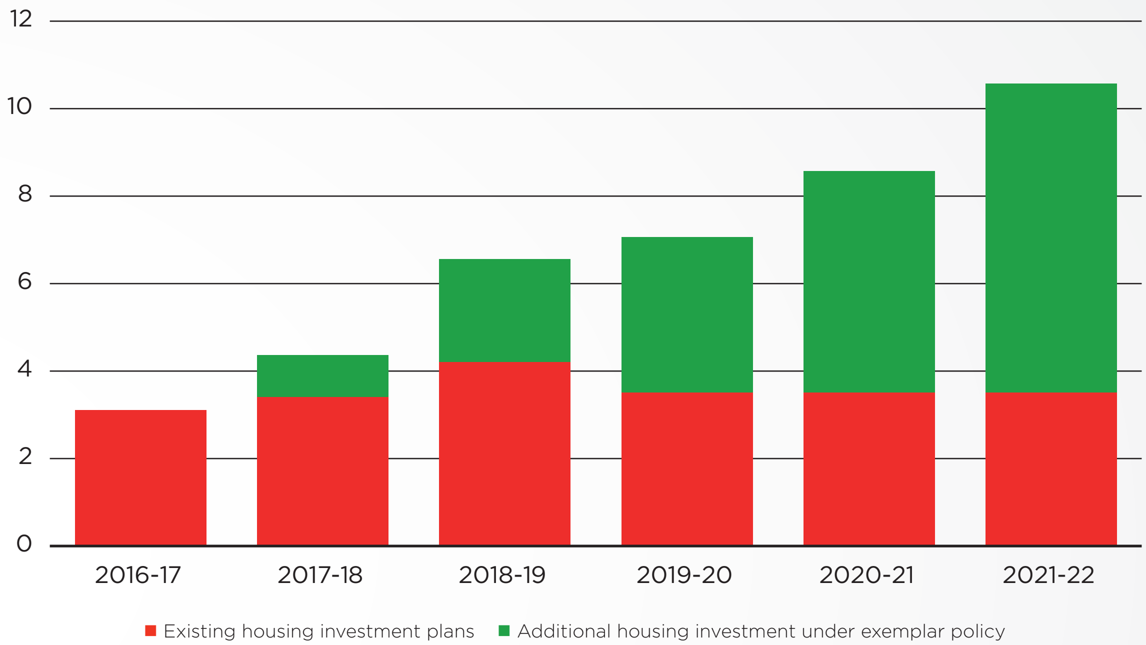
But the policy does create a net annual surplus for the government under all of the tested scenarios by year 26 at the latest. Over 50 years it would generate material savings to the exchequer, ranging from £102 billion to £319 billion (in today's prices). Although the net impacts vary, they show that even under a range of plausible outcomes after Brexit, the case for investing in new social housing remains strong.

An increase in investment helps to boost employment and domestic demand at a time of economic weakness in the low growth scenarios. Unlike other kinds of infrastructure investment, social housing has the additional merit that, once built, the costs of management and maintenance are paid for by the rents tenants pay, in contrast to, for example, roads and schools.

The exemplar policy has the significant benefit of adding more than four million homes to Britain's housing stock over 50 years. This would be an important step towards reversing the country's failure to build enough homes to meet demand. Delivering these new homes for social rent would help families in need and have knock-on social benefits to the wider economy beyond the potential savings to the public purse. These knock-on social benefits touch areas of public interest such as health, wellbeing and education and productivity, and affect all age groups in society.

ADDITIONAL SPENDING IN CONTEXT

Figure 4: Additional housing investment required over the first five years (£ billions, current prices)



Sources: Capital Economics and Department for Communities and Local Government, *Annual Report and Accounts 2015-16* (Department for Communities and Local Government, London), 2016. Note: The additional housing investment varies across the different scenarios. This chart shows the scenario with the greatest investment requirement.

It is clear that delivering the exemplar policy of 100,000 new homes for social rent would save the taxpayer money in the long-run. This does require up-front investment from the government, however, and it is sensible to consider how short-term spending requirements would be affected and the practicality of implementing the policy.

We are realistic that there cannot be a step change in residential construction overnight – but a steady build-up to 100,000 new social rent homes annually by 2022-23 is reasonable. This gives adequate time for the construction industry to develop sufficient capacity.

The exemplar policy would require additional borrowing from the government. This varies by scenario and, in 2021-22, ranges from £6.6 billion to £7.0 billion (in nominal terms). This is small change compared with likely government spending of over £800 billion that year[2] and is equivalent to just two weeks' worth of existing spending on the National Health Service.[3] (See Figure 4.)

At first glance, one might think this increased borrowing goes against the government's commitment to achieve a fiscal surplus. But this fails to recognise that not all borrowing is the same. It would be quite right to be concerned about an increase in public debt in order to fund the day-to-day costs of public services. Borrowing to invest or save, as for this policy, is prudent however and would likely be welcomed rather than met with alarm.

[2] The latest forecast for total managed expenditure in the preceding year (2021-22) is £841.1 billion. See: Office for Budget Responsibility, *Economic and fiscal outlook March 2016* (Office for Budget Responsibility, London), 2016.

[3] HM Treasury, *Public Expenditure Statistical Analyses 2016* (HM Treasury, London), 2016.

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