Consultation on Pay to Stay: Fairer Rents in Social Housing

Response of the Association of Retained Council Housing

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About ARCH

1. ARCH represents councils in England and Wales that have chosen to retain ownership of council housing and manage it themselves. Our 65 member councils own and manage over 600,000 homes.

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Consultation questions

2. The consultation paper invites views on how the 'pay to stay' scheme can better support incentives to work, and on the likely administrative costs of the scheme. Our response addresses both issues, but we conclude that it is impossible to provide an adequate assessment of the likely impact of alternative options for the scheme without better data than is currently available, both on the level of market rents that would be chargeable on council properties, and on the characteristics and regional distribution of the households likely to be affected. We argue that before proceeding to the detailed design of the scheme, the DCLG needs to collect better information from local authorities on market rents for council properties and give further consideration to the characteristics and regional distribution of tenants liable to be classed as "high income". In order to ensure that any final scheme is practicable, we urge DCLG to take forward detailed proposals in close consultation with affected local authorities and housing associations.

3. On the basis of the evidence available, we conclude that:

- The policy as set out in the Budget statement would be unlikely to deliver the assumed public expenditure savings and that therefore the aspiration in paragraph 8 of the consultation paper that the detailed design of the policy should be able to deliver the same savings is unrealistic.
- There is wide regional and local variation in the gap between current council rents and market rents council properties would attract, such that in a significant number of local authority areas, as illustrated in Table 1 below, it is unlikely that the additional income collectable would justify the additional costs of administering a 'pay to stay' scheme.
- In other areas, however, a scheme that raised rents to 80% of market levels at £30,000 of household income, and 100% of market at £40,000 would cause considerable hardship and have significant and perverse impacts on work incentives. A tapered increase of rents with household income would be fairer and reduce to some extent the adverse impact on work incentives, but would be likely to add significantly to the administrative complexity of the scheme and the associated costs of administration. On balance, we would prefer to see the income thresholds raised so that rent increases are only required of tenants better able to afford them.
- The proposal for higher thresholds in London, so that tenants with £40,000 household income pay 80% of market rent and the full market rent would only apply to tenants with household income of £50,000 or more, goes some way towards mitigating the impact of the larger gap between council and market rents in London, but would still leave many tenants facing unacceptably high rent increases. However, tenants in some high-value areas outside London would face substantial rent increases at the lower income threshold of £30,000. We conclude that a single threshold for England outside London is inappropriate and the scheme should provide for local thresholds set according to local housing market conditions.

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- The government plans that the National Living Wage should reach £9 an hour by 2020. On this basis, a household including two earners working 35 hours a week would have an annual income of £32760. We do not believe such a household can credibly be described as "high-income", and that the threshold for the scheme should be set above this amount in all areas, and increased annually in line with planned increases in the National Living Wage.
- We argue that the thresholds set for each area should also be no less than the income necessary to access owner-occupation in the same area with assistance where necessary through schemes such as starter homes, Help to Buy etc.
- We see no credible justification for requiring the additional income raised from councils operating the 'pay to stay' scheme to be paid to central government. We accept the importance of reducing public expenditure, but would point out that equivalent savings, and more, could be realized by not applying the proposed social rent reductions in part or in full to some or all of those tenants not in receipt of HB. We would be happy to accept arrangements through which the government could be reassured that the additional income would be used to support much-needed housing investment before allowing it to be retained.

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Council rents and market rents

4. We note that, in the press release issued alongside the consultation paper, DCLG asserts that introduction of a compulsory 'pay to stay' scheme would "put an end to the situation where higher-income social tenants benefit from taxpayer-funded subsidies of up to £3500 a year". We do not believe this is an accurate description of the current position. This amount of "subsidy" we understand to be based on an estimate of the gap between current council rents and the market rents that would be chargeable on council properties, sometimes described as economic subsidy. We argue below that this is probably an overestimate.

5. Whatever the amount, however, it is misleading to describe this as a "taxpayer funded subsidy". Council housing has been self-financing since April 2012, and for several years before that, the Exchequer benefited from receipt of council rent surpluses generated by the fact that rent income was greater than the costs incurred in running council housing. This point is well-made in the Research Briefing prepared for the Housing and Planning Bill by the House of Commons Research Library[i]

6. The Impact Assessment prepared by DCLG for the Housing and Planning Bill estimates that, if tenants with income over £30,000 (£40,000 in London) paid 80% of market rent and those with income over £40,000 (£50,000 in London) paid the full market rent, 130,000 tenants would initially be affected (para 4.4.11), and the additional rent initially payable by them (before any behavioural effects are taken into account) would be £400 million, an average of £3076 per tenant, or £59 per week. We set out below evidence that suggests that this estimate is too high.

7. So far as we are aware, the last systematic estimate by DCLG of the market rents that would be chargeable on council properties was that provided by Steve Wilcox in 2009 as part of the Review of Council Housing Finance[ii]. Based on 2007/08 data, he found council rents to be on average 63% of market rents, but with substantial regional variation ranging from 59% in London to 70% in the North East. From that time until April 2015, the government's policy was for council rents to increase annually by 0.5% above RPI, in all regions, plus an allowance of up to £2 per week for convergence, in accordance with government rent guidelines. Over the years for which data is available actual council rent increases, in aggregate, have closely followed the guideline increases. The guideline rent increase from April 2015, was 1% above CPI.

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8. Over the same period, average private market rents have increased substantially, but the ONS argues that this is partly attributable to the growth of the sector to include more properties in affluent areas. The ONS private rental housing index is designed to provide a price index measure which compares "like for like" rent increases. The ONS index shows substantial regional variation in private rent increases since 2007/08. Comparing October 2007 (taken as the mid-point of 2007/08) with October 2013, the average increase for England as a whole was 11.8%, but with a range from 4.5% for the East Midlands to 19.7% for London. This is not unexpected given the differential movement of house prices over the same period.

9. In the table below, we compare actual council rents for each region for 2013/14 with an estimate of the market rent for those properties calculated by updating Wilcox's estimates in line with the regional increase in the ONS index since 2007/08.

Table 1: Comparison of current council rents with estimated market rents 2013/14, by region

Region	Current rents (£ p.w.)	Market rents (£ p.w.)	Current as % of market rents
North East	70.26	77.81	90%
North West	70.56	80.13	88%
Yorkshire & the Hur	69.55	79.05	88%
East Midlands	72.14	85.28	85%
West Midlands	75.64	89.12	85%
East of England	84.87	118.85	71%
London	101.45	156.04	65%
South East	85.12	125.83	68%
South West	74.24	100.94	74%
England	82.44	109.15	76%

10. On this basis, Table 1 shows that council rents in England in 2013/14 were, on average, at 76% of market levels, compared with 63% in 2007/08. This is consistent with the observation made in DCLG's Impact Assessment of the Social Rent Reductions proposed in the Welfare Reform and Work Bill that, in the decade to 2014, social rents rose by over 60% while private rents increased by 23% between 2005 and 2015. Presumably the figure for private rents relies on the ONS index, as we have done.

11. It should be emphasized that the estimates in Table 1 are of regional averages, underlying which there is likely to be significant variation between and within individual local authority areas. In many local authorities there is likely to be wider variation in market rents than among the council rents charged in different areas for the same property size, and between the rents charged for larger and smaller dwellings. Thus, for example, we are aware of a one-bedroom flat in Wandsworth with a council rent of £125 a week that would be likely to attract a market rent of £325 (an increase of 160%). Conversely there are likely to be many other cases where the gap between council and market rents is much lower than the regional average would suggest. The design of any 'pay to stay' scheme needs to take careful account of the fact that the impact of the policy could vary widely from tenant to tenant even where their household composition and income are the same.

12. Consequently, the estimates in Table 1 are consistent with the possibility that the gap between council and market rents in some London boroughs may be £3500 a year or more, but the London average is rather lower at £2840. The estimated average difference for England as a whole is £1388, or £26.71 per week. This would make it very unlikely that the policy exemplified in the Impact Assessment for the Housing and Planning Bill would yield £59 per week per case, unless those affected were overwhelmingly concentrated in London and in larger properties.

13. Table 1 also shows that the regional variations apparent in Wilcox's estimate and in changes in the ONS index since 2007 combine to widen differences between regions in a way that has crucial implications for the design of any 'pay to stay' scheme. In the five regions covering the North and Midlands, the estimate suggests that average council rents are already above 80% of market, in the East and South West regions they are between 70% and 80%, while in London and the South East they are below 70%.

14. On this basis, in the five Northern regions, a 'pay to stay' scheme that charged 80% of market rents at an income threshold of £30,000 and the full market rent at £40,000 would affect only tenants with incomes over £40,000 – many fewer than estimated - and in none of these raise an average of more than £700 per case in additional rent. On the basis of the likely caseload and the additional income per case, it seems probable that in many local authorities, particularly in these regions, the likely income yield would not justify the costs of setting up and administering a scheme.

15. National data on actual council rents in 2014/15 and 2015/16 are not yet available. The guideline increase for 2014/15 (RPI + ½%) was 3.2% excluding the allowance for convergence, and that for 2015/16 (CPI + 1%) was 2.2%, a total of 5.5% for the two years together, excluding the convergence allowance. Between October 2013 and July 2015, the ONS index for England increased by 3.5%, but with a continuing pattern of regional variation. In the North East and North West regions, the index increased by less than 1%, while London registered a 5.1% increase. This suggests that the conclusions drawn above from 2013/14 data remain valid.

16. While the estimate above must be assumed to be subject to a significant margin of error, it is sufficient to cast doubt on the assumptions made in the Budget Statement and Impact Assessment. We therefore argue that, before proceeding to the detailed design of the 'pay to stay' scheme, the government should ask local authorities to carry out a rigorous assessment of the market rents that would be chargeable on a representative sample of their properties, to provide better data than is currently available on the impact of potential design options.

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Supporting work incentives

17. The government is right to be concerned that the scheme as described in the Impact Assessment will have a very damaging effect on work incentives. The scheme as exemplified includes two "cliff edges" where rents would be sharply increased – at £30,000 and £40,000 (£40,000 and £50,000 in London). The impact would vary widely from tenant to tenant, depending on the specific relationship between the current and market rent for each individual tenancy. In London, however, our estimate suggests that the average impact on a tenant with income of £40,000 would be £23.38 a week, with an additional £31.21 a week payable at income £50,000. In individual cases, the increases involved could be much higher. The size of these "cliff edge" increases is so large as to provide substantial disincentives to increase productivity and a perverse incentive to cut working hours or avoid promotion or overtime in order to keep income below the applicable threshold.

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18. The Consultation paper invites views on the introduction of a simple taper so that rents increased more gradually with income to reduce work disincentives. We have a number of observations to make about this:

    - To avoid a "cliff-edge" at the household income threshold of £30,000 (or £40,000 in London) the taper would have to extend to lower income levels, bringing much higher numbers of tenants within the scope of means-tested rents, with consequent implications for administration costs. It would also highlight the inconsistency between the government's current proposal to reduce rents for tenants with household income less than £30,000 and its concern that the 'pay to stay' scheme should not undermine work incentives. The impact of the scheme on work incentives would be substantially mitigated by disapplying the rent reductions wholly or partially from tenants not on HB.
    - The taper could apply to the actual rent charged or to the proportion of market rent charged at a particular income level. Applying the taper to the proportion of market rent charged would mean that the work disincentive effect would vary according to level of the market rent, so that means-testing operated differently for those on lower incomes, eligible for HB, from those on higher incomes. This point is considered further in the next paragraph. Applying the taper to the actual rent would remove the inconsistency with HB.
    - The impact of a taper on work disincentives will also depend on whether gross or net income is used in the rent calculation. By 2017, tenants in households with incomes below £40,000 will be basic rate taxpayers and if employees, subject to Income Tax and NI deductions of 32p for each additional £1 of earnings. Above this level, a significant proportion of both single and dual earner households will be higher rate taxpayers whose marginal rate of tax is already 52%. Basing rent on gross income could add a further 10-20% to these tax rates. It may be judged fairer to base rents on income net of tax and NI contributions (as with HB).
    - The government also needs to consider whether it is fair to apply the same approach to households with and without dependents.

19. If, for example, the government decided to introduce a taper requiring tenants to pay 80% of market rent at gross income £30,000 to 100% of market rent at household income £40,000 (outside London) the effective taper rate would be 2% of market rent for each additional £1000 of income. The estimate in Table 1 is that the average market rent in England in 2013/14 was £109.15 per week or £5676 a year; 2% of this is £113.51, a taper rate of 11.35%. But this would vary from region to region, with the same calculation for the South East region producing a taper of over 13%. These are regional averages, and for individual tenancies the numbers could be much higher.

20. In London, assuming the higher income thresholds in the Budget Statement, tenants with household incomes below £40,000 would pay no more, but those with incomes between £40,000 and £50,000 would face an average taper of 16%. Rates well in excess of 20% could apply in individual cases. Many of these would be higher rate taxpayers already facing a marginal tax rate of 52p in each additional £1 earned.

21. The government's proposal to apply a higher income threshold for London and a single threshold for the rest of England produces other anomalies. University towns such as Oxford and Cambridge and areas adjoining London in the East and South East regions have market rents at near-London levels, yet tenants in these areas would become liable for higher rents at £30,000 rather than £40,000. The average tenant on £30,000 in the South East region could expect to pay an average rent of £100.66 (80% of market), while a tenant on the same income in London could expect to pay an average of £101.45, and see this rent reduced over the next four years. Many tenants on £30,000 to £40,000 in high value areas in the East and South East would face higher rents than tenants in London on the same incomes.

22. The attraction of a taper system of some kind is that it would increase rent more gradually as income increased. However, as we have sought to argue, there are several significant issues to be addressed in the design of such a system if it is to minimize unfairness to particular groups of tenants. A real danger is that amendments to the scheme designed to reduce unfairness add significantly to the administrative complexities and costs of the scheme. We would be particularly concerned if, for example, means-testing were to apply to tenants with incomes less than £30,000.

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Other behavioural impacts

23. In this section we discuss the likely impact of 'pay to stay' on tenants with household incomes above the threshold of £30,000 (£40,000 in London) proposed in the Budget Statement. We refer to these as higher-income tenants, as it is a misnomer to describe them as "high-income". The government plans that by 2020 the National Living Wage will reach £9 an hour. A household with two earners working 35 hours a week on the NLW will have a gross annual income of £32,760. If they have two children, their net income, as estimated in Table 1.8 of the Budget Report, will be £33,730. The same table estimates that a similar household in which one earner works 35 hours for the median wage and the other 16 hours for the NLW will have net income of £35,480. Both would be subject to the current 'pay to stay' proposals if they live outside London. Yet it is not credible to refer to either as "high-income", except relative to households in which there is only one, or no, earner.

24. 'Pay to stay' is likely to have other behavioural impacts than those produced by work disincentives. As the name of the policy implies, the government clearly expects that some higher-income tenants will choose to move out rather than pay higher rents. Others may choose to exercise their right to buy.

25. Some higher income tenants may be eligible for a mortgage that would enable them to exercise the right to buy, but have so far chosen to continue to rent. Given the increased discounts and promotion of right to buy since 2012, it does not seem likely that they are numerous. Many others will be unable to exercise their right to buy because their annual income is insufficient, or subject to fluctuation, or because they are too close to retirement. In London, an annual income of £40,000 is insufficient on its own in most boroughs to finance purchase of a 2 or 3-bedroom dwelling even with the benefit of a right to buy discount or other assistance through the starter homes initiative, Help to Buy etc.

26. For a higher income tenant who cannot afford to buy, but chooses to leave their council tenancy for a private sector tenancy, there is no advantage in moving to an equivalent property in the same area, where they would face broadly the same rent, and lose the benefits of a high standard of management and maintenance and the rights of a secure tenant. The only rational choice would be to move to a cheaper area, aggravating the demographic polarization already evident in London and other higher-value areas. The government should think carefully before introducing a policy likely to drive more key workers – as many higher-income tenants are likely to be – out of areas where they are particularly needed.

27. The Prime Minister has said that the government's aim is to replace Generation Rent with Generation Buy. To be consistent with that objective, design of the 'pay to stay' scheme should, we believe, seek to minimize the number of affected tenants who no choice but to move away or pay to stay. The best way to achieve this would be for the government should base the household income threshold for each area on the income necessary to access home ownership in that area, after taking account of assistance through the starter homes initiative, Help to Buy etc.

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Administrative costs

28. The administrative costs involved in operating the 'pay to stay' scheme could vary widely according to the administrative complexity of the scheme and the frequency with which rents, and therefore household circumstances, are reviewed. We note the estimates included in the Impact Assessment, with transitional costs for local authorities ranging from £7.5 million to £22.5 million, and annual administration costs of £10-£14 million. It is hard to comment on these although it must be said that the implication that administrative costs can be as low as £50 to £70 per case seems ambitious.

29. Transitional costs will go well beyond the costs of setting up systems for collecting and handling income data. Tenancy agreements will need to be amended, and the implications of the new scheme communicated to tenants. In many cases this will require home visits to be carried out.

30. There will also be significant issues to address if the scheme relies, as does the voluntary 'pay to stay' scheme, on the income of the two highest earners in the household. These may not include the tenant, and may not currently even be named on the tenancy agreement. Yet the tenant will remain liable for any additional rent payable after their income has been taken into account. There will need to be new arrangements to keep track of, and collect income information from, other members of the household. This issue does not arise with HB administration, which relies on fixed non-dependent deductions.

31. We note that the Capita Users Group response to this consultation argues that the timetable for the necessary system changes would make it impossible to introduce the scheme by April 2017. We find their argument compelling and urge DCLG to consider it carefully.

32. The simplest option to administer may be to review rents annually, basing income on HMRC data for the preceding tax year, as for the current voluntary 'pay to stay' scheme. However, there would need to be provision to exempt tenants whose financial circumstances had worsened in the intervening period, or during the period that the increased rent is in force. Tenants whose income had increased recently might not be subject to an increased rent for up to two years, but we believe any attempt to backdate liability would be fraught with difficulties including an increase in household debt.

33. The alternative of administrative arrangements that more or less replicate those for Housing Benefit or Universal Credit, involving much more frequent reviews based on current income data would, we believe, be substantially more expensive to administer and is preferably avoided.

34. We argue above that the margin between current council and market rents may be smaller than the government has assumed, particularly in the Midlands and North. Transitional costs and administrative costs per case are likely to be the same whether the additional rent collectable is £5 or £25 per tenant per week. It would be prudent, as we argue, for the government to collect better information on the market rents that would be chargeable on council properties in each local authority area before carrying out detailed design work on the thresholds and administrative parameters of the scheme.

35. We have also commented on the choice between a simple scheme that includes a "cliff edge" where rent is increased sharply, and options for a fairer scheme that increases rents more gradually as income increases. A scheme with a taper is likely to add significantly to administrative costs. Once these are considered, it may become clear that the choice is between a scheme that is expensive to administer and collects relatively small amounts from a large number of tenants, and an alternative based on simpler principles and higher thresholds which is easier to administer and collects more per case from a smaller number of tenants better able to afford it. On balance, our preference is for the second option.

36. In particular, we believe that a threshold household income of £30,000 is too low. It would mean some tenants in receipt of Housing Benefit or Universal Credit able to claim a contribution towards their higher rent, and it would bring dual earner households in receipt of the National Living Wage within the scope of the scheme before 2020. Both outcomes would compromise the government's ambitions for welfare reform and a higher-wage economy. We would argue that the thresholds should be set at least high enough to avoid any overlap with Housing Benefit and Universal Credit entitlement and ensure that they do not apply to any household earning no more than the National Living Wage. For this reason, they should also be raised in future in line with increases in the National Living Wage.

37. We have also argued that the thresholds should be set for each local area at a level of income no less than that necessary to access owner-occupation in the same area, with help through current initiatives where available. We believe that a mandatory scheme based, apart from London, on a single national threshold and possibly taper, is likely to have a highly variable impact given the wide variation in local housing market conditions, creating perverse incentives with unpredictable outcomes. A better alternative would be for the government to set a national framework within which local authorities would design and implement local schemes appropriate to local circumstances. We would be happy to work with the DCLG to design such a scheme.

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Use of additional rental income

We see no credible justification for treating local authorities differently from housing associations by requiring the additional income raised from councils operating the 'pay to stay' scheme to be paid to Central Government. We accept the importance of reducing public expenditure, but would point out that equivalent savings, and more, could be realized by not applying the proposed social rent reductions in part or in full to some or all of those tenants not in receipt of HB. We would be happy to accept an arrangement through which, individual local authorities wishing to retain the additional income, would be expected to enter an agreement with the Secretary of State that it would be used to support necessary housing investment, similar to the arrangements that apply to the reuse of additional capital receipts from the reinvigorated Right to Buy.

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[i] http://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-7331, page 58

[ii] http://webarchive.nationalarchives.gov.uk/20120919132719/http://www.communities.gov.uk/publications/housing/rentspolicyanalysis