Social Rent Policy: Choices and Trade-Offs

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Preface

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Executive Summary

- Social housing providers – local authorities and housing associations – fulfil at least three functions: building housing, acting as landlord and delivering subsidised rent levels. This report focuses on the last of these.

- Specifically, we analyse the consequences for tenants, social housing providers and the exchequer of changing the level of rent charged to tenants in social housing. We do not take a view as to what level is appropriate, or look at wider policy issues in the social housing system.

Background

- About one-sixth of the population of Great Britain currently live in social housing, down from about one-third in the early 1980s. On average, social tenants have much lower levels of education, employment and earnings than the population as a whole – gaps which widened dramatically during the 1980s and early 1990s.

- The average social rent in England is currently about £96 per week, which is an estimated £40 (30%) below the average market rent that would be chargeable on social properties. But there is wide variation across the country: all of those averages are significantly higher in London and the south-east and significantly lower in the north of England. Two-thirds of social tenants receive further help with the cost of their rent in the form of housing benefit, a means-tested benefit.

- There have been important changes to social rent policy in England in recent years. Since 2011, rents for most new social tenancies have been allowed to be much higher than previously, under the 'Affordable Rent' model which allows rents at up to 80% of market levels. For existing social tenancies, a 10-year period of real annual increases (CPI + 1%) was planned to apply from 2015–16; only for an announcement in the July 2015 Budget that instead mandated four years of 1% annual nominal reductions in social rents from 2016–17. The Budget also announced that higher-income social tenants will have to pay market or 'near market' rents from 2017–18, in a policy known as 'Pay to Stay'.

Sub-market rents and housing benefit

- Although housing benefit is better suited than social housing to providing a comprehensive 'safety net' for those in need, it is withdrawn as tenants' incomes increase and this can weaken their work incentives. An important role played by sub-market rents in social housing is to reduce tenants' reliance on housing benefit and hence the weak work incentives often associated with it.

- Since social tenancies have traditionally been granted for life, tenants could improve their circumstances without fear of losing their access to sub-market rents in the way that they could lose their housing benefit. However, continuing to provide sub-market rents after tenants' circumstances improve makes social housing less closely targeted on those currently in need. In addition, all else equal, a guarantee of a lifetime of subsidised rents (currently worth about £2,000 a year on average) increases the relative attractiveness of qualifying for social housing in the first place, and of staying in it thereafter even if more suitable housing might be available in the private sector. There is little systematic evidence on how far people respond to these incentives to qualify for, and stay in, social housing.

Consequences of changing social rents

- Increasing social rent levels makes social tenants not on housing benefit worse off, but among tenants who do receive housing benefit – generally the less well-off – most will find that it rises to cover the rent increase and hence their income after paying rent is unchanged.

- By increasing the amount of housing benefit going to social tenants, a rent rise typically weakens work incentives, because housing benefit is means-tested against current income and so is often reduced when tenants move into work or increase their earnings.

- Increasing social rent levels reduces the financial incentive to gain access to social housing in the first place and to stay in it thereafter. One advantage of a rent rise is that those who leave – or who no longer apply for – social housing as a result are, almost by definition, those most willing to live in the (higher-cost) private sector. Hence social housing should become more closely targeted on those who value it most (relative to living in the private sector).

- Raising social rents will increase central government expenditure on housing benefit for the two-thirds of social tenants who claim it – though it will of course mean more rental income for social landlords, and central government may choose to recoup some or all of that from them.

- To the extent that social landlords get to keep the extra rental income and reinvest it in more social housing, sub-market rents will ultimately be extended to more tenants. On the other hand, higher social rents encourage tenants to take up their Right to Buy, which is likely to worsen local authorities' financial position (since Right to Buy is heavily subsidised) and hence reduce the number of social properties (or the rent subsidy per property) that they can sustain.

- As well as affecting those whose rents are increased, therefore, increasing rent levels might ultimately also have knock-on effects on the availability and/or cost of social housing for others. The overall distributional and incentive effects of changing social rent levels will ultimately depend on how

these indirect effects play out. This is not something we address in our quantitative analysis.

Quantifying the impact of changing social rents in England

- The July 2015 Budget announced that social rents will be reduced by 1% a year for four years from 2016–17. This represents an expected overall reduction of 12%, or £600 per year on average, relative to previously-announced plans to increase rents by CPI inflation + 1% per year. This will reduce rental income for social landlords by a total of £2.3 billion a year by 2019–20, with £1.3 billion coming from housing associations and £1.0 billion from local authorities.

- Since most social tenants receive housing benefit and see it fall (typically one-for-one) if their rent is reduced, this policy largely represents a transfer from social landlords to the exchequer, rather than to social tenants. The £2.3 billion reduction in rents breaks down into reduced housing benefit spending by the exchequer of £1.7 billion and increased net-of-rent incomes for social tenants of £0.7 billion (assuming full take-up of housing benefit).

- The tenants who gain from this will tend to be towards the middle of the income distribution: better-off households are less likely to be in social housing, while the poorest will typically be receiving housing benefit and see it fall one-for-one as their rent is reduced.

- We also quantify the impact of this reform (and others) on the financial work incentives of social tenants. We distinguish between the incentive to be in paid work at all and the incentive for those in work to increase their earnings slightly – whether by working more hours, seeking promotion or moving to a better-paid job.

- We measure the financial incentive for an individual to be in work at all by the replacement rate (RR), which is their household income if they do not work as a percentage of their household income if they do work, and by the participation tax rate (PTR), which is the proportion of their total earnings taken in tax and withdrawn benefits. We measure the financial incentive for workers to increase their earnings using the effective marginal tax rate (EMTR): the proportion of a small increase in earnings taken in tax and withdrawn benefits. In all cases, higher numbers mean weaker work incentives.

- Of course, many other factors affect people's employment and earnings too, and not everyone is equally likely to respond to such incentives, but there is strong evidence that these financial incentives do affect many people's behaviour.

- The 12% reduction in social rents (relative to previous plans) announced in the July 2015 Budget will strengthen social tenants' work incentives on average: it will reduce their average RR by 0.3 percentage points (ppts), the

average PTR by 0.9ppts and the average EMTR among workers by 0.9ppts. For comparison, cutting all rates of income tax by a penny would reduce social tenants' average RR by 0.1ppts, the average PTR by just 0.2ppts and the average EMTR of those in work by 0.6ppts.

- If social rents rose to 80% of market rents (as allowed for new tenancies under the oddly-named 'Affordable Rent' model), the effects would differ significantly across households, notably in different regions. Social rents would increase by an average of 41% in London but only 14% in the north-east. Among those who lost, households in London would lose an average of £1,600 a year, compared with £317 a year in the north-east. The weakening of social tenants' work incentives would be correspondingly greater in London than in England as a whole.

- In 2013, the government introduced a cash limit on the benefits that most non-working families can get, and this cap is to be lowered from 2016. For those – still relatively few – affected by the benefit cap, an increase in social rents can actually *strengthen* their incentive to be in work. For most tenants, out-of-work income (net of rent) is unaffected by a rent rise as their housing benefit rises one-for-one to cover it, whereas their in-work income will be reduced if they earn too much to be entitled to housing benefit. But for those affected by the benefit cap, a rent rise reduces their out-of-work income as their housing benefit cannot rise to cover it, whereas the rent rise reduces their in-work income only if they earn too much to be entitled to housing benefit.

'Pay to Stay'

- From April 2017, social landlords will be required to charge tenants with incomes above £30,000 (£40,000 in London) market or 'near market' rents. This will reduce the incomes of approximately the highest-income 7% of social tenant households (around 250,000) and weaken the incentives some social tenants face to move into work or increase their earnings.

- The government is currently consulting on precisely how social rents should increase as income rises beyond the 'Pay to Stay' threshold. This choice has important implications for the impact of the policy on revenues, incomes and work incentives.

- If rent jumps up to market levels as soon as a family's combined taxable income reaches the Pay to Stay threshold (a 'cliff edge'), we estimate that the total annual increase in rent paid would be £800 million (a hefty average increase of £3,000 a year per affected household) if no one changed their behaviour to avoid the rent rise. The government has stipulated that the part of the rent increase collected by local authorities (rather than housing associations) must be handed to the exchequer. This would amount to about £250 million per year.

- However, introducing a cliff edge would create inequities and a potentially damaging set of incentives for social tenants with incomes around the threshold. It is difficult to justify otherwise-identical social tenants whose incomes differ by £1 facing a difference in rent of thousands of pounds per year. In addition, such a system would create big disincentives for social tenants to increase earnings over the threshold. Any pay rise that meant crossing the threshold would actually make the recipient worse off, unless the pay rise was worth more – after tax – than their direct rent subsidy (typically thousands of pounds).

- The government could instead raise rents by, say, 50p for every pound of income over the threshold (a 50% 'taper rate'). In this scenario, rents would rise, and households' net-of-rent incomes would fall, by a total of around £600 million per year (£2,400 per affected household), raising the exchequer around £200 million. The work incentives of social tenants would still be weakened – the average RR of social tenants would rise by 0.5ppts, the average PTR by 1.5ppts and the average EMTR among working social tenants by 3.6ppts – but it would avoid the inequities and extreme disincentive effects associated with a cliff edge.

- There is a delicate trade-off around choosing the taper rate. A lower taper rate implies a smaller increase in average rents (and hence revenue for housing associations and the exchequer), lessens the extent to which direct rent subsidies are targeted at lower-income households and raises EMTRs for a larger number of people (since it stretches the taper further up the income distribution). On the other hand, a higher taper rate risks creating very weak incentives to increase earnings for the smaller number who are on the taper (as rents rise quickly with income).

Universal credit and social rents

- Universal credit is a new means-tested benefit which is gradually replacing six existing means-tested benefits and tax credits for those of working age: income support, income-based jobseeker's allowance, income-related employment and support allowance, child and working tax credits, and housing benefit.

- Universal credit will slightly dampen the effect of changing social rents on the incomes and work incentives of social tenants. More working social tenants will be entitled to universal credit (51%) than are entitled to housing benefit under the current benefit system (36%). This means that more working households will see a change in rent completely offset by a change in their benefit entitlements, leaving incomes and work incentives unaffected.

Social rent policymaking

- Recent policy on social rents displays a worrying lack of consistency. The July 2015 Budget announcement of four years of rent reductions came after just

one year of increasing rents by CPI + 1% – a policy that the coalition government had said would apply for 10 years with the stated aim of providing certainty. Rent reductions for existing social tenants also sit awkwardly with the ongoing policy of allowing for substantially higher rents for new social tenancies under the 'Affordable Rent' model. A case can be made for higher or lower social rents. But a lack of stability and clarity of purpose creates unnecessary uncertainty for tenants looking to plan their budgets and it risks undermining the ability of social housing providers to plan their investments, or to secure finance for those investments at low cost given the potential increase in perceived risk around their level of future rental income.

1. Introduction

This report analyses the choice over the level of rent charged to tenants in social housing – that is, those renting from local authorities or housing associations.

The rising cost of housing, and the lack of housing supply that is at least partly responsible for it, are increasingly pressing issues. They give rise to many potential areas of concern, including intergenerational equity and the functioning of the labour market. Because housing is a basic necessity, one of the most common concerns is over the potential impact of high housing costs on the living standards of the most vulnerable – or the growing price that the taxpayer must pay to insulate people from those rising costs.

Much attention has been focused on housing benefit – a means-tested benefit to cover rental costs – the cost of which has more than doubled in real terms since 1990 and which now accounts for 1.3% of national income.[1] But there is another form of subsidy that is provided to many tenants deemed in need (and to about one-sixth of the population overall): the provision of housing at below-market rents in the social rented sector. The size of that subsidy is the subject of this report.

Significant changes to social rent policy have recently been introduced or are in the pipeline. These include two policies announced in the July 2015 Budget: to reduce social rents in England by 1% per year for the next four years, and to charge market or 'near market' rents to some higher-income tenants.

The effects of changing social rents are wide-ranging. There is a need to set out systematically what the consequences are. Changing social rent policy can affect the living standards and incentives of social tenants, the public finances and the revenue available to social housing providers – which in turn can affect the number and quality of homes provided through the social sector, and hence the overall supply of housing and the wider housing market.

Some of the trade-offs involved remain under-studied and we lack a thorough quantitative understanding of them. A central focus of this report is on the distributional and work incentive impacts of recent and imminent changes to social rent policy. Although work undertaken for a number of years has quantified in detail the impacts of changes to policy on tax and cash benefits in these respects, the same is not true of social rent policy – despite the fact that social rents are below market levels and hence represent a subsidy to those in social housing in much the same way as housing benefit does. This report helps to fill this gap in our understanding. It also includes a quantitative assessment of how the benefit cap and the introduction of universal credit will affect the relationship between social rents, work incentives and living standards for social

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[1] Source: Department for Work and Pensions, 'Benefit expenditure and caseload tables 2015', https://www.gov.uk/government/statistics/benefit-expenditure-and-caseload-tables-2015.

tenants: policymakers should be aware of the interaction between social rent policy and benefit policy.

We should be clear about what this report does not do. We do not take a view on how high social rents should be. That depends in part on subjective political judgements that it is not our place to make. Rather, we set out, and where possible quantify, what the trade-offs are, with the aim of facilitating informed choices in this area. We also do not address the question of how the level of social rents should vary according to factors such as geography or property size. Finally, our focus is just on choices over the level of rent in the social housing sector. It is therefore narrower in scope than a full analysis or review of the whole system of social housing in the UK (for which interested readers should see Hills (2007)).

The report proceeds as follows. Chapter 2 provides the necessary policy and institutional background (readers already familiar with the social housing system in the UK can skip this chapter). Chapter 3 discusses the trade-offs involved with social rent policy. Chapter 4 quantifies the distributional and work incentive effects of different social rent policies, and the revenue consequences for the exchequer and for social housing providers. Chapter 5 concludes. A briefing note published alongside this report (Adam et al., 2015) expands on the factual background behind the social housing system given in Chapter 2.

2. Policy Background

Social housing refers to rented housing provided by local authorities (LAs) and housing associations (HAs), typically at sub-market rents. LA housing is often referred to as 'council housing'. HAs are not-for-profit bodies that provide low-cost housing. They are technically designated as private sector institutions but receive significant subsidy from the public sector, tied to new housing construction (see Box 2.1 for a brief overview and history of HAs). Both the LA and HA rental sectors are subject to significant central regulation over things such as housing quality and the terms of tenancies, as well as the level of rents.

This chapter discusses in turn the distinct functions of, and potential justifications for, social housing; how it is financed; how it is allocated; who lives

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Box 2.1. A brief overview and history of housing associations

Housing associations are private sector not-for-profit bodies that provide rental homes at sub-market rents, made possible by public subsidy on the cost of new homes.

The sector is heavily regulated. Central government effectively largely determines rent levels and mandates certain quality standards. Governance and financial viability are currently regulated by the Greater London Authority in London, the Homes and Communities Agency in the rest of England, the Scottish Government, Welsh Government and the Northern Ireland Housing Executive.

HAs in some form have a long history stretching back to the almshouse movement, but they began to develop in a more recognisable form during the 19th century as charitable bodies providing housing for those in need. It was not until the 1980s, though, that they started to play a sizeable role in the overall provision of social housing.

The 1980s saw two changes that propelled the growth of HAs. First, HAs emerged as the preferred alternative to LA development of new social housing. Sharp cuts in government spending on housing and strict limits on the ability of LAs to borrow meant that new building by LAs declined rapidly. In contrast, from 1989 HAs were allowed to borrow outside of the public borrowing and accounting regime.

The second factor underlying the expansion of HAs was the Large Scale Voluntary Transfer (LSVT) programme – introduced via the 1985 Housing Act – which allowed for LA housing stock to be transferred en masse to (typically newly-created) HAs. The LSVT programme had a number of aims, including bringing in private finance to tackle accumulated backlogs of repairs without increasing public borrowing, and bringing (presumed) private sector efficiencies into the sector. Since 1988, 1.3 million homes have been transferred to HAs in this way (Heywood, 2013).

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in it; the rents that they pay; and the role of housing benefit in subsidising those rents.

Although much of the background provided here applies throughout the UK social housing system, many of the institutional details and specific social rent policies differ between the constituent nations of the UK. Where this is the case, we focus on the system in England, as a full treatment of the system in all parts of the UK is beyond the scope of this report. However, some of the basic facts about social housing can be provided at a Great Britain or UK level, and we do that where possible.

2.1 The different functions of social housing

The social housing sector in the UK combines at least three functions, which are typically justified in different ways and address distinct problems.[2]

The provision of housing at sub-market rents is a central purpose of social housing. Sub-market rents are one of two main ways in which the state provides support for the cost of rented housing, alongside housing benefit (HB). The direct subsidy provided to a tenant through sub-market rent is the difference between their actual rent and the market rental value of the property. The considerations that govern the appropriate level of rents in the social sector – or, equivalently, the appropriate level of direct rent subsidy – are the primary focus of this report.

In addition to providing a mechanism for delivering subsidised housing, social housing allows the state to act as landlord (in the case of LA housing) and to regulate the relationship between landlords and tenants in the HA sector. This 'landlord' function of social housing allows the state to control, for example, the terms of tenancies and the provision of maintenance and other services in a more direct way than in the private rented sector, or to overcome the need for regulation by direct provision. Economic rationales for government intervention in what landlords do might be based on the idea that there are asymmetries of information between landlords and tenants. In the absence of intervention, these could lead to inefficiency – for example, landlords maintaining properties less than they otherwise would, because some of the effects of that maintenance are not visible to prospective tenants and therefore cannot be priced into the rent. Alternatively, there may be a distributional motivation for intervention. For example, if it is costly for tenants to search for and/or move to a new property, this could give landlords 'market power': they may choose to neglect maintenance issues that arise mid-tenancy which they would otherwise have had to address. Preventing such neglect may effectively transfer resources (in this

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[2] For a discussion of the economic rationale behind the different elements of social housing, see Whitehead (2002).

example, the cost of maintaining a property well) to tenants that would otherwise have been extracted by their landlords.[3]

Finally, the social housing sector is the primary route by which the state has subsidised new construction. Economic arguments for government intervention to increase investment in construction typically point to various reasons why, left alone, the private sector might invest less in housing than is desirable from a social perspective. For example, financial markets may be imperfect, and this might hold private investment in housing below its desired level. Or society may place a higher value than private individuals on benefits that lie far in the future – such as the benefits to future generations of having a high-quality housing stock. Investment in new social housing is one way of generating higher levels of investment.

The relative priority of these different roles has changed over time: in the 1950s and 1960s, improving the quantity and quality of the housing stock was a prominent objective of social housing policy, whereas improving the affordability of housing for those on low incomes now seems to take priority.

Although these distinct roles of social housing in the UK are typically bundled together, in principle they are separable. For example, the state could abdicate its role as builder while maintaining its role as landlord and rent-setter by purchasing private properties and letting them at sub-market rents. Alternatively, the state could continue subsidising rents without being a landlord or builder – as is largely the case in Germany, where sub-market rents are delivered through tax concessions and direct subsidies to private landlords, and as is currently done in the UK private rented sector through HB.[4] Equally, the state could continue to build housing and to provide and/or regulate the activities of landlords, even if social rents were increased to market levels. Indeed there are international examples of social housing at market, or even above-market, rents – notably from Sweden and the Netherlands.

Hence, in principle, we can think about the appropriate level of rents without necessarily coming to a view about how far government should intervene to increase investment in construction or to provide or regulate landlord services. In practice, though, the way that the institutions of social housing are structured in the UK means that we do need to bear in mind important potential interactions between the level of social rents and factors such as the amount of housing construction. These are discussed more fully in Chapter 3.

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[3] Alternatively, asymmetries of information and/or market power could favour tenants. For example, landlords might not be able to keep perfect track of how well tenants are maintaining their property and/or it can be costly or legally prohibited for landlords to change tenants.

[4] Hills, 2007, p. 24.

2.2 Social housing finance

Housing associations have to raise revenues, largely through rents, that are sufficient to cover their direct costs in terms of management, maintenance and debt servicing. HAs are non-profit organisations, so any revenues over and above these costs must be reinvested in social housing. The financial situation of local authorities is similar, in that LAs' housing budgets (known as the Housing Revenue Account, HRA) are ring-fenced from the rest of LAs' budgets: the direct costs of providing social housing must be covered by revenues (largely rents) from within their housing budget, and LAs cannot transfer any surplus revenues out of their HRA.

Prior to 2012, the system of LA financing was different. LAs received an additional source of revenue in the form of a so-called 'HRA subsidy' from central government. This covered the difference between an LA's *assumed* (rather than actual) costs and revenues, based on assumptions about things such as rent levels and the cost of servicing debt in that LA (in cases where assumed revenues exceeded assumed costs, LAs instead paid an amount back to the government, i.e. they received a 'negative subsidy'). The HRA subsidy system was essentially a way of evening out the funds available to different LAs for spending on things other than debt servicing – for historical reasons, some LAs had larger debt servicing costs than others. The Localism Act 2011 effectively redistributed debts between LAs with the aim of removing the need for revenue subsidies. Hence, LAs are now 'self-financing' in terms of their day-to-day spending and revenues.

The direct rent subsidy on a socially-rented property is the difference between the actual rent and the level of rent that could be charged on that property if it were in the private rented sector. This means that the total rent subsidy that the social housing sector can provide (without any additional transfers from central government) is the difference between the revenue social landlords would generate at market rents and the direct costs of management, maintenance and debt servicing plus any up-front costs of new social housing investment. We can think of this as the 'budget constraint' faced by social housing providers.

Social landlords are able to provide direct rent subsidies because their direct costs are typically much lower than the revenue they would get if they charged market rents. Key reasons for this are that (i) the state has a long history of providing grants for the construction of new social housing, resulting in lower debt servicing costs for social housing providers; (ii) rapid house price inflation since much of the debt was taken on has increased the gap between market rent levels and debt servicing costs; and (iii) much of the social housing stock is sufficiently old that debts have been paid off.

Given the budget constraint described above, there is a trade-off between the subsidy per property and the total number of socially-rented properties. An increase in rent levels would reduce the value of direct rent subsidies per property provided through social housing; but ultimately the additional rental income should be reinvested in social housing, and new construction is one of the

obvious ways in which such reinvestment can occur (though the extent to which it can occur depends on other factors, including the functioning of the credit market and the planning regime). The balance that is struck between providing larger subsidies per property and a larger number of properties therefore depends on the social rent policy set by central government. In practice, of course, the government may introduce other changes to the funding of social housing at the same time as changing rent policy, as has happened recently (see Section 2.5 and further discussion in Chapter 3).

2.3 Allocation and security of tenure

Since rents in social housing are below market levels,[5] for many people it is a more attractive option than trying to rent (or buy) housing on the open market, and LAs and HAs must decide who should be granted access to this scarce resource. The degree of rationing required is, of course, dependent on the balance of demand and supply, which varies significantly across the country. Access is determined by social landlords primarily on the basis of applicants' assessed need. Legislation requires that certain groups are given 'reasonable preference' by LAs, including the homeless, those living in overcrowded or unsanitary conditions, and those who need to move for medical reasons; and HAs must offer some lettings to LA-approved applicants.[6] Beyond these requirements, LAs and HAs have considerable freedom to determine who is qualified to apply for social housing and the relative priority given to different applicants.

Until 2012, there was a legal requirement to let most social housing on 'the most secure form of tenure possible'. As a result, almost all current social tenancies are 'secure tenancies'. Perhaps the most significant feature of secure tenancies is that they are 'lifetime tenancies': they are granted for an unlimited duration without any form of periodic review.

The Localism Act 2011 allowed social housing providers to offer fixed-term tenancies in England, typically for at least five years. Providers now have discretion over what type of tenancy to offer to whom. The rationale for fixed-term tenancies is that social housing is a scarce public resource that should be 'focused on those who need it most, for as long as they need it'.[7] Put another way, as social tenants' circumstances change over time, so should their entitlement to direct rent subsidies. In 2013–14, 12% of new social tenancies in England were let on a fixed-term basis, taking the number of fixed-term tenancy agreements made in 2012–13 and 2013–14 to around 2% of the total social housing stock.[8] In

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[5] Of course, other differences between the social and private housing sectors, such as security of tenure, may also affect the relative attractiveness of the sectors.

[6] Legislation also prohibits LAs from considering certain applicants who are ineligible on account of their immigration status: see Wilson (2015a).

[7] Department for Communities and Local Government, 2010.

[8] Source: Number of new lettings from table 1a and number of fixed-term tenancies from table 2b in Department for Communities and Local Government, 'CORE summary tables: 2013 to 2014',

the July 2015 Budget, the government announced plans to review, and ultimately limit, the use of lifetime tenancies. However, the use of fixed-term rather than lifetime tenancies has implications for incentives as well as for targeting of those in need. We discuss these implications in Chapter 3.

2.4 Who lives in social housing?

About 16% of the population of Great Britain currently live in social housing. That proportion has been in decline since the early 1980s, when the sector housed almost 35% of the population. At the same time, HAs have become an increasingly important part of the sector: they accounted for a tiny fraction of social housing in the early 1980s, but now account for about half (see Figure 2.1).

Figure 2.1. Percentage of the population of Great Britain living in social housing
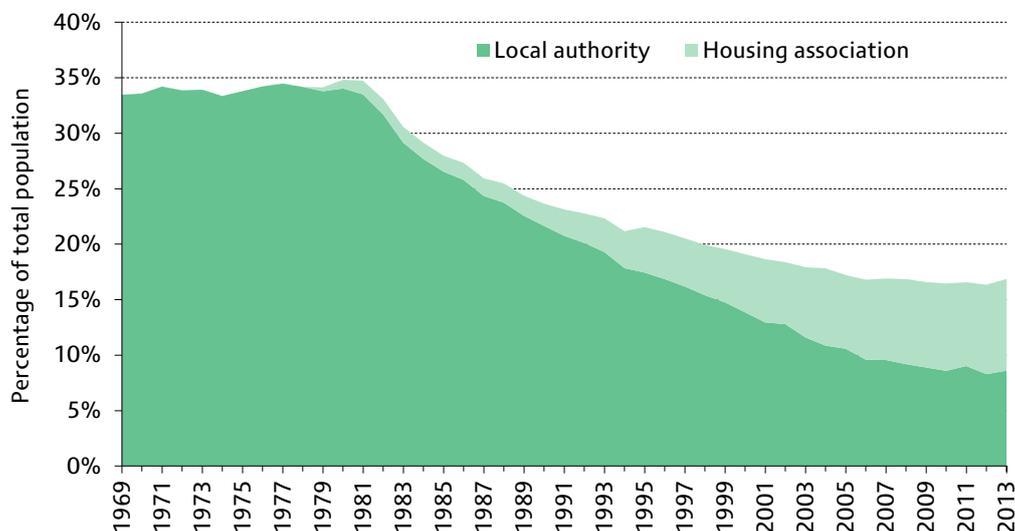
Note: Total population includes children. Years are calendar years to 1992 and financial years from 1993 onwards (where 1993 refers to the financial year 1993–94). Estimates are based on pooled three-year samples (for example, the '1969' data point is actually based on data from 1968, 1969 and 1970) up to and including 1993, and single years of data thereafter.
Source: Family Expenditure Survey and Family Resources Survey, various years.

This decline in the overall size of the sector has been driven by two major factors. First, there has been a massive flow of properties out of the social sector (specifically the LA sector) under the Right to Buy, which was introduced in 1980 and gave tenants in LA housing the right to purchase their home at a heavily discounted price. Between 1980 and 2013, more than 2.5 million properties were sold under Right to Buy across Great Britain, with LAs allowed to retain only a fraction of sale revenues to fund new construction.[9] Second, over and above not

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https://www.gov.uk/government/statistics/social-housing-lettings-in-england-april-2013-to-march-2014. Total social housing dwelling stock in England at the end of 2013–14 (31 March 2014) from Department for Communities and Local Government (2015b).

[9] LAs were initially able to use receipts from Right to Buy sales to finance new capital work (not restricted to housing), but by the mid 1980s central government had limited the amount that

using all the proceeds from Right to Buy to replace the sold-off housing, there was a large decline in construction of new social housing relative to previous levels after large cuts to grants from central government: completions of new social housing fell from almost 150,000 per year in the 1970s to around 33,000 per year in the 1990s and 25,000 per year in the 2000s. Since the early 1990s, HAs have been responsible for virtually all new social housing completions. See Adam et al. (2015, figure 2) for more details.

Characteristics of social tenants

Social housing is allocated broadly on the basis of an assessment of resources relative to need. It is therefore no surprise that social tenants have relatively low incomes: in 2013–14, median net household income among social tenants (before housing costs, and adjusted for household size) was 66% of median income for the population overall.[10]

Table 2.1. Characteristics of social tenants in Great Britain compared with those of the population overall (2013–14)

	All social renters	All
Employment rate (aged 16–64)	49.2%	72.4%
Median weekly earnings (those in work aged 16–64)	£276	£403
Age		
<16	24.3%	18.4%
16–64	59.9%	64.4%
65+	15.8%	17.1%
Has a degree (aged 25–64)	8.2%	29.0%
Receiving disability benefits (aged 16–64)	17.6%	6.1%
Household type		
Single	13.4%	7.8%
Lone parent	8.1%	3.0%
Couple without children	7.4%	18.4%
Couple with children	17.4%	20.2%
Pensioner	21.2%	21.6%
More than one family	32.6%	29.1%

Source: 2013–14 Family Resources Survey. Earnings uprated to 2015–16 levels in line with average earnings growth.

could be spent in any one year to 25% of the previous year's receipts plus 25% of receipts from earlier years – effectively requiring that spending to be spread over longer periods of time. From 1990, councils were only allowed to retain 25% of Right to Buy receipts, with the rest going to the Treasury. See Reeves (2014, p. 139).

[10] Authors' calculations using Family Resources Survey, 2013–14. Incomes adjusted for household size using the modified OECD equivalence scale.

Most of the gap in terms of income between social tenants and the rest of the population is due to differences in earnings from employment. As Table 2.1 shows, social tenants are less likely to work, and have lower earnings if they are in work, than the population overall. In part, lower employment rates reflect the fact that just 60% of social tenants are of working age (16–64) compared with 64% in the population overall. More importantly, even among the working-age population, the employment rate among social tenants is less than 50%, compared with over 70% for the population overall. Median weekly wages for social tenants in paid work are less than 70% of median weekly wages for the population of workers overall.

Social tenants also differ from the rest of the population in other ways, some of which help to explain these differences in income and earnings. For example, social tenants are much more likely to be in receipt of disability benefits, and much less likely to have a degree. They are also much more likely to be single, and more likely to have children.

The differences in economic outcomes between social tenants and the rest of the population have not always been this large. Figure 2.2 shows median household income, the employment rate and median wages among social tenants as a percentage of those of the population overall since 1979. What is striking is how small the gap between social tenants and the rest of the population was in 1979, and how this widened dramatically during the 1980s. This probably reflects the fact that better-off social tenants disproportionately left the sector by exercising

Figure 2.2. Ratio of social tenants' employment rates, median earnings and median weekly net household income to those of the population overall (Great Britain)
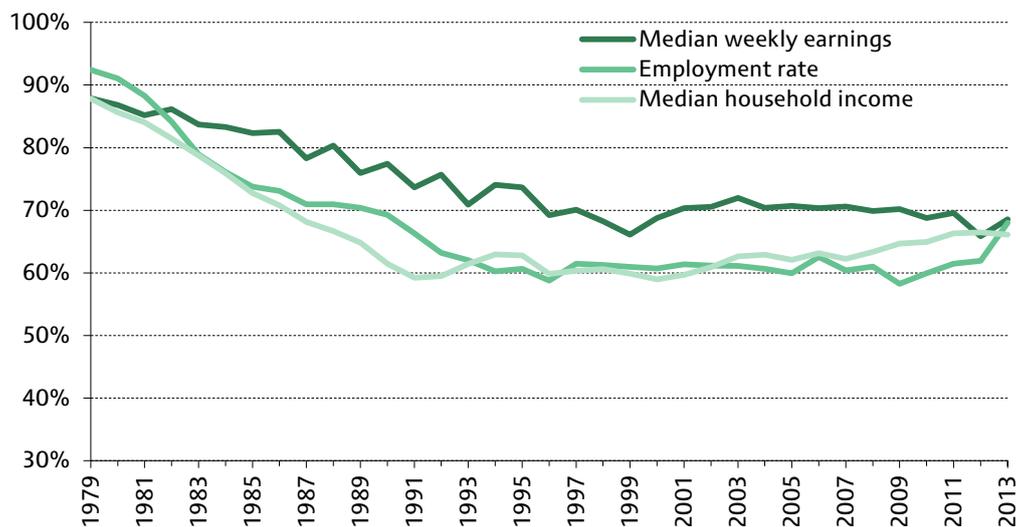
Note: Median household income is the net equivalised household income of the median individual before housing costs. Employment rate is among 16- to 64-year-olds. Median weekly earnings are among earners aged 16–64. Years are calendar years to 1992 and financial years from 1993 onwards (where 1993 refers to the financial year 1993–94). Estimates are based on pooled three-year samples up to and including 1993, and single years of data thereafter.
Source: Family Expenditure Survey and Family Resources Survey, various years.

their Right to Buy, while allocation of the remaining social housing – now scarcer – was increasingly targeted on those with lower incomes.

The fact that social tenants have much lower earnings or potential earnings than the rest of the population, and that this difference has grown over time, has important consequences for work incentives – something we discuss in more detail in Chapter 3.

2.5 Rents in the social housing sector

Providing housing at rents below the market rate is central to the social housing sector in the UK, and indeed is a mandatory requirement. Rent levels across the social housing sector are constrained by central regulations. Since 2001, rent setting in social properties has been based on a 'formula rent'. The formula was introduced with the aim of bringing an end to arbitrary differences in rent between similar properties within and between different localities, and in particular to achieve convergence between LA and HA rents. The formula is based on:

- relative local earnings levels;
- the relative value of the property (where local earnings are given a larger weight than relative property value, at a ratio of 70:30);
- the number of bedrooms in the property (rents as a proportion of market rents have traditionally been lower for larger social sector properties, and the formula explicitly retained this differential);
- the national (England) average rent for HA properties (since a key aim was to achieve convergence in rents between HAs and LAs).[11]

LA rents used to be well below formula rents, so once formula rents were brought in, a period of gradual 'rent convergence' was undertaken: formula rents were uprated each year by RPI inflation + 0.5% but, for properties below formula rent, year-on-year rent increases were allowed to be (up to) £2 per week larger than that.[12]

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[11] Precisely, the formula rent for 2001–02 was arrived at by computing a notional 2000–01 formula rent and uprating it by RPI inflation + 1% (4.3%). The notional 2000–01 formula rent was {(70% of average HA rent) x (relative county earnings) x (bedroom weight)} + {(30% of average HA rent) x (relative property value)}. For these purposes, 'average HA rent' was the mean rent in HA properties in England in April 2000; 'relative county earnings' meant earnings in the county where the property is located divided by the England average, where the earnings measure is average gross weekly earnings of full-time manual workers between 1997 and 1999, uprated to 1999 prices; 'bedroom weights' were a set of scaling factors, ranging from 0.8 for bedsits to 1.4 for properties with at least six bedrooms; and 'relative property value' meant the property's capital value as a proportion of the England average for HA properties as of January 1999. After 2001–02, the formula rent was simply increased by a uniform percentage across the country each year, which, until 2015–16, was RPI inflation + 0.5%. For more details, see Department for Communities and Local Government (2014), particularly appendix A.

[12] Although the process of 'rent convergence' is largely complete, in some cases limits on the rate at which social rents can be increased mean that social rents on some properties are still below their formula level.

Social landlords are free to set rents below the formula rent level or up to 5% above it, subject to the maximum annual increases discussed below (and the constraint that, whatever the rent level, they must meet required quality standards). As they are effectively self-financing in terms of day-to-day revenues and spending (see Section 2.2), they have to absorb the consequences of choices over rent levels elsewhere in their budgets.[13] For example, rents below the formula rent are likely to mean less spending on maintenance, management or new construction than rents at the formula level, all else equal.

In addition to the rent formula, which largely determines relative rents between properties, central government regulates changes in the average level of rents via maximum annual increases. In the 2013 Budget, the Conservative–Liberal-Democrat coalition government announced that, from 2015–16, increases in social rents in England would be capped at CPI + 1% for a period of 10 years. At the time, it was claimed that this long-term commitment would provide certainty to providers over future revenues, enabling them to develop long-term business plans and to fund investment in new construction. However, this commitment was undermined after just one of the 10 years of supposed certainty: in the July 2015 Budget, the new Conservative government decided instead to reduce nominal rents in the social sector by 1% per year for a period of four years from 2016–17 (before reverting to the previously-announced policy of annual increases of up to CPI + 1%). Given current Office for Budget Responsibility (OBR) forecasts for CPI inflation, the policy implies a 12% reduction in rents by 2019–20 relative to previous plans, and has given rise to concerns about the impact on providers' financial position and hence their ability to invest in new social housing.[14]

Table 2.2 shows average (mean) rents in 2015–16 in the social and private sectors. Taking England as a whole, the mean social rent (£96 per week) is less than 60% of the mean rent in the private sector (£172 per week). Some of this difference is accounted for by the subsidy to rents in the social sector, but some other differences between the private and social sectors will be relevant too. For example, properties in the social sector may be in less desirable areas or of lower physical quality than properties in the private rented sector. The third column in Table 2.2 contains estimates of the mean rent that could be charged on the actual social housing stock were it in the private rented sector (see Section 4.1 for details of how this is calculated). This is lower than the mean rent on private properties – suggesting that social housing is indeed, on average, of lower quality (or in less desirable locations etc.) than private rented housing. Note that 'quality' here will incorporate the market value of other features of social tenancies that

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[13] This was also true before LAs became fully self-financing in 2012 (see Section 2.2). From 2002, the HRA subsidy that they received from central government was calculated using assumed rental income based on the formula rent, so the subsidy was insensitive to LAs' actual rent setting, meaning that LAs faced the full financial consequences of deviating from the formula rent.

[14] For example, see P. Apps, 'Landlords prepare to cut development after rent shock', *Inside Housing*, 9 July 2015, http://www.insidehousing.co.uk/business/development/landlords-prepare-to-cut-development-after-rent-shock/7010697.article.

Table 2.2. Mean rent per week by rental sector and English region in 2015–16

	Private rents	Social rents	Market rent on social properties	Social rent subsidy (£)	Social rent subsidy (% of market rent)
England	**£172**	**£96**	**£136**	**£40**	**29%**
North East	£118	£81	£99	£18	18%
North West	£120	£80	£98	£18	19%
Yorkshire and the Humber	£130	£86	£109	£23	21%
East Midlands	£121	£82	£110	£27	25%
West Midlands	£130	£89	£118	£29	24%
East	£143	£91	£135	£44	33%
London	£267	£123	£191	£68	36%
South East	£177	£107	£166	£59	36%
South West	£150	£95	£142	£47	33%

Note: Private rents uprated to 2015–16 levels in line with average private rent growth. London private rents uprated by growth in average London private rents. Social rents uprated in line with rules governing formula rents.
Source: Authors' calculations using estimates of social rent subsidies in Wilcox (2008) and Family Resources Survey, 2010–11 to 2013–14.

are different on average from private tenancies, such as management or maintenance services and security of tenure. But the market rents for social properties are also higher than actual social rent levels, highlighting the genuine economic subsidy for rents in the social sector. Across England as a whole, we estimate that rents in socially-rented properties are on average £40 per week lower than the market rent that would be chargeable on the same property. This implies an economic subsidy of about 30% of the market rent, on average. That subsidy is likely to grow, given the 1% annual nominal cuts to social rents now planned for the next four years (see above).

In absolute terms, the average value of direct rent subsidies is largest in London, at £68, followed by the rest of the South East, while the average direct rent subsidy is smallest in the north of England, at just £18. A similar pattern holds if we look at the value of direct rent subsidies as a proportion of the market rent. London is again at the top end, together with the South East – both regions have average direct rent subsidies of almost 40%, compared with about 20% in the north.

The 'Affordable Rent' model

In 2011, the coalition government introduced a new 'Affordable Rent' tenure in England: social housing with rents designed to fall somewhere between current market and social rents. Despite the name then, the key feature of this model is that rents are allowed to be more expensive than the traditional social rent model

that they are partially replacing. Rents set under this new model, which can apply only to new properties or re-lets of existing vacant properties, must be at least equal to the formula rent and are allowed to be as high as 80% of the market rent for the property (conditional on an agreement to use the additional rent for reinvestment in social housing – see below). As was shown in Table 2.2, this compares with an average of about 70% of market rents across the social sector in England currently (and closer to 60% on average in London and the South East).[15]

The introduction of Affordable Rents is closely tied to the Affordable Homes Programme (AHP) – a new framework for allocating capital grants from central government between social housing providers, introduced by the previous (coalition) government and continued by the current Conservative government. A central aim of the AHP has been to shift the source of funding for new construction in the social sector away from capital grants (which have been heavily cut) and towards greater borrowing by social landlords. The idea is that higher rents increase providers' expected future rental income and therefore their capacity to borrow (since the debt is typically secured against future revenue). For the most part, social landlords in England can only charge Affordable Rents as part of an agreement with the Homes and Communities Agency to use additional revenue to fund new supply.[16]

Properties let at Affordable Rents represent a small but growing proportion of the flow of new tenancies, increasing from fewer than 5,000 new lettings in 2011–12, the first year of the programme, to more than 37,000 in 2013–14, or 9% of all new lettings in England. With about 10% of the social housing stock re-let each year, it will take some time for Affordable Rents to become a substantial part of the sector overall: in 2013–14, they represented less than 2% of the total social housing stock in England.[17]

The latest data suggest that Affordable Rents are, unsurprisingly, higher than traditional social rents. According to Department for Communities and Local Government (DCLG) estimates, median social rents (including Affordable Rent properties) across England as a whole were 57% of median market rents in 2013–14, compared with 80% for Affordable Rent properties (note that neither figure adjusts for differences in property characteristics between Affordable Rent

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[15] The national policy covering year-on-year rent changes also applies to properties let at Affordable Rents: rents will fall in nominal terms by 1% per year for four years from 2016–17, before reverting to the previously-announced policy of annual increases of up to CPI + 1%.

[16] The vast majority of capital grants are made through the Affordable Homes Programme. Provision has also been made for providers to start charging Affordable Rents outside the AHP – see Wilson and Bate (2015).

[17] Source: Table 1a at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/387420/CORE_Statistical_Release_2013-14.pdf for number of new lettings per year; table 100 at https://www.gov.uk/government/statistical-data-sets/live-tables-on-dwelling-stock-including-vacants for size of total social housing stock in England.

properties and other social properties).[18] The fact that Affordable Rents are higher, on average, than social rents probably reflects – at least partly – the fact that providers are taking up the freedom to charge higher rents (up to 80% of the market rate) than they could if they let the same property at the formula rent – though it may also reflect differences in quality between the properties let at Affordable Rent and other social properties.

'Pay to Stay'

The July 2015 Budget announced an important change to the way in which rents are set within the social sector. From 2017–18, social landlords will be required to charge market or 'near market' rents to tenants in England with a 'household income' of £30,000 or more (£40,000 in London).[19] The government has yet to confirm precisely what it will count as 'household income' for these purposes. The policy, known as 'Pay to Stay', extends a reform introduced by the previous coalition government that allowed (but did not require) landlords to charge market rents to tenants with income in excess of £60,000.[20] For that policy, the definition of income used was the total taxable income of the tenant and (if applicable) the partner with whom they live. Assuming that the same definition of income is used for the new extended Pay to Stay, we estimate that about 7% of social tenant households in England have an income above the relevant threshold (£40,000 in London or £30,000 elsewhere) and will therefore pay more rent as a result of the policy.[21]

Important details of the policy are yet to be announced and an official consultation on some of the details is currently under way.[22] We discuss some of the most important choices in Section 4.3. But it is clear that, although it will affect only a minority of tenants, Pay to Stay represents a fundamental change to the way in which rents are set in the social sector: previously, social rents could depend on the characteristics of the property but by law could not depend on tenant characteristics; in future, they will also depend on tenants' current incomes.

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[18] This does not mean that Affordable Rents are being set at the upper limit of 80% of the market rents. Unfortunately, there are no administrative data on how Affordable Rents compare with market rents on the same properties, and there are not enough data for us to estimate this using survey data as we do for social rents as a whole in Table 2.2. See tables 2c and 2d at https://www.gov.uk/government/statistics/social-housing-lettings-in-england-april-2013-to-march-2014.

[19] HM Treasury, 2015a.

[20] For more details on this policy and the discussion around it, see Wilson (2014).

[21] Authors' calculations using the IFS microsimulation tax and benefit model, TAXBEN, and the 2013–14 Family Resources Survey.

[22] Department for Communities and Local Government, 2015a.

2.6 Housing benefit for social housing tenants

Housing benefit is a means-tested benefit available to tenants with low incomes and low financial assets to cover some or all of their rent. It exists in both the social and private rented sectors, but the rules governing entitlements differ

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Box 2.2. Calculating housing benefit entitlement for social tenants

The maximum housing benefit a social tenant family can receive is their actual rent.[a]

Since April 2013, the social sector size criteria (the so-called 'bedroom tax') reduce maximum HB by 14% or 25% for those who have one or two more bedrooms (respectively) than they are deemed to need based on their household's characteristics.

Maximum HB can also be reduced based on the income of any non-dependent adults in the household (excluding the claimant's partner – typically adult children or elderly relatives), who are expected to contribute towards the rent.

Families receiving a means-tested out-of-work benefit – that is, income support, income-based jobseeker's allowance, income-related employment and support allowance or pension credit guarantee credit – automatically qualify for maximum HB. Other claimants must undergo a separate means test, which compares the family's income with a measure of their minimum needs which is based on their age, whether single or in a couple, number of children and any disability. If the family's income is below their assessed needs, they qualify for maximum HB; otherwise, their HB is reduced by 65p for each £1 of income in excess of their assessed needs until their entitlement is exhausted.

For the purposes of the means test, family income is measured after deducting income tax and National Insurance contributions and includes some (but not all) social security benefits and tax credits. A small amount of earnings can be deducted (depending on family type), as can childcare costs (up to a limit) if all adults in the family work, and half of pension contributions. Income from savings (other than pensions) is not included, but non-pension financial assets above £6,000 (£10,000 for pensioners) are assumed to generate income of £1 a week for each £250 of savings (£500 for pensioners), and savings above £16,000 eliminate HB entitlement altogether.

Since 2013, there has been a cap on the total benefits that most non-working families can get (see page 45), which is implemented through the housing benefit system. In other words if, without the cap, a family's total benefit income would exceed the cap, HB is reduced by the difference.

One implication of the way HB is calculated which is important for the purposes of this report is that, except for families affected by the benefit cap or the 'bedroom tax', if rent increases then HB entitlement increases pound-for-pound.

[a] Throughout this report, 'family' is defined as an adult plus any partner and any dependent children living with them.

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between the sectors. Box 2.2 explains how HB entitlements are calculated for social tenants. Around two-thirds of social tenants receive some HB[23] (slightly more are entitled to it, but about 12% of those social renters entitled do not take it up[24]).

The interaction between social rents and HB is crucial for understanding the impact of changing levels of social rents on the incomes and work incentives of social tenants. In particular, as explained in Box 2.2, HB entitlement typically changes one-for-one in line with any changes in social rents: a £1 increase or decrease in social rent leads to a £1 increase or decrease in HB. As a result, in many cases, changes in social rents have no effect on net-of-rent incomes for social tenants. As we shall see in the next chapter, however, changes in social rents affect work incentives for a much wider group of tenants.

Two reforms to HB in 2013 mean that, for certain groups, the one-for-one link between changes in rents and changes in HB no longer holds. First, 'maximum' (pre-means-test) HB for working-age people in social housing has been reduced by a fixed percentage of their eligible rent if they are deemed to be under-occupying their property (by 14% for one bedroom more than is deemed necessary, and by 25% for two or more). For this group, therefore, increases in HB will cover only a fraction of any increase in rents (86% and 75% for those with one or two 'spare' rooms, respectively).

Second, benefits for each non-working family of working age have been subject to an overall cap (except where specific exemptions apply, such as being in receipt of personal independence payment or disability living allowance). If total weekly family income from certain specified benefits exceeds the cap, then HB payments are reduced in order to bring family benefit income down to the cap level. For families at the cap, small changes in rent have no effect on benefit entitlement.

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[23] Source: Department for Work and Pensions, 'Benefit expenditure and caseload tables 2015', https://www.gov.uk/government/statistics/benefit-expenditure-and-caseload-tables-2015; Department for Communities and Local Government, live table 102, https://www.gov.uk/government/statistical-data-sets/live-tables-on-dwelling-stock-including-vacants.

[24] Source: Department for Work and Pensions, 'Income-related benefits: estimates of take-up: financial year 2013–14', https://www.gov.uk/government/statistics/income-related-benefits-estimates-of-take-up-financial-year-201314.

3. Social Rent Levels: The Trade-Offs

The question central to this report is: 'What are the consequences of changing rent levels in the social housing sector?'. In this chapter, we provide a framework for thinking about this question, before modelling and quantifying some of the effects in Chapter 4. In Section 3.1, we highlight the differences and trade-offs between the two key instruments of affordable housing policy in the UK, namely sub-market rents and housing benefit (HB). Section 3.2 sets out the implications of changing social rent levels for tenants, social housing providers and central government.

3.1 Sub-market rents versus housing benefit

The UK operates two systems that, in combination, provide help with the cost of renting to those with low resources relative to their needs: sub-market rents in the social rented sector, and HB in both the private and social sectors. In this section, we briefly discuss some of the potential rationale for operating these two systems side by side, and then examine the trade-offs between providing more support via sub-market rents versus via HB.

Sub-market rents provide a subsidy to those deemed most in need of it based on information available at the time of allocation to social housing. On their own, sub-market rents would not provide a complete 'safety net' guaranteeing a minimum level of housing provision for those who fall on hard times. First, although social tenants pay rents below the market rate, there is still no guarantee that their income (excluding HB) would be sufficient to cover their subsidised rent whilst leaving them with enough to spend on non-housing goods and services to provide a living standard deemed acceptable. Second, the availability of sub-market rents is limited by the number of social rented properties. There is no guarantee that the size of the sector will match the level of need at any point in time, and in practice there are far fewer social rented properties in the UK than families deemed in need of support (of course, the sector could expand, but this would take a lot of time and money).

Hence it is not hard to see why a large HB system has developed on top of the system of sub-market rents which predated it: to cover the (already-subsidised) rents of the poorest social tenants and to support relatively poor families in the private rented sector. The level of support provided by HB is directly linked to measures of families' current resources and rental costs, and there is no limit on the number of people who can claim HB in the private sector if their assessed needs are great enough.

In principle, HB could provide a 'safety net' to cover rental costs fully for all those in need, in a way that sub-market rents do not. Now that we have an HB system, then, why might we still want to retain sub-market rents at all, rather than letting HB take all the strain?

One important reason why we might want to provide subsidies through both mechanisms is that the two systems have very different impacts on incomes and incentives. There is a trade-off between the extent to which support is targeted on those whose resources are low (relative to their housing needs) and the effect on people's incentives. Any benefits (in this case, access to rent subsidies) that are dependent on people having certain characteristics, such as low incomes, give people a financial incentive to gain or keep these characteristics. For a given amount of subsidy, the redistributive impact will be greatest if support is targeted on those with the lowest resources (typically, though not always, measured by income). However, this will also create a financial incentive for people to remain on a low income, so as to retain their eligibility for support. This is a trade-off between redistribution and incentives similar to that facing many policies that aim to alleviate poverty (see, for example, Adam, Brewer and Shephard (2006)). Because eligibility for sub-market rents and for HB are assessed in different ways, using a combination of the two gives the government more scope to finesse the trade-off. This is a focus of the remainder of this chapter and the next.

It is important to be clear that the size of any behavioural response to an incentive is distinct from the size of the incentive itself. Many people might not respond to an incentive at all, even if the incentive is large. A related point is that there are many non-financial considerations that can affect people's behaviour (including decisions about paid work), and in some cases those might be more important than financial factors. In short, a large literature tells us that some people's work decisions certainly do respond to financial incentives, but that this responsiveness varies across groups. This is discussed more fully in Section 4.1.

There are other reasons why governments might prefer to deliver support through sub-market rents in social housing rather than HB alone. For example, providing subsidies to private tenants through HB may push up rental prices, shifting part of the benefit from the tenant to the landlord. In contrast, the use of social housing allows the government to control rent levels directly, thereby ensuring that the subsidy benefits the tenant in full. Direct rent subsidies also somewhat reduce the numbers claiming HB, because lower rents mean both that fewer people are entitled to HB and that those entitled to HB have less need of it and are less likely to take up their (lower) entitlements. Direct rent subsidies therefore reduce the scope of the continual means-testing associated with HB which entails administrative costs for government and hassle and stigma for claimants (though there are also costs associated with the apparatus of social housing). We do not examine these arguments further here.

Sub-market rents, housing benefit and incentives

A key difference between sub-market rents and HB lies in the way in which eligibility is determined. The two subsidies fall at almost opposite ends of a spectrum in terms of the frequency with which the means test used to allocate them is updated to reflect current measures of resources and need.

At least until recently, access to sub-market rents (via allocation into social housing) was effectively subject to a means test that was not repeated after a tenant was allocated social housing. The details of this means test are partly at the discretion of social housing providers, and – unlike for HB – the rules may not be entirely and explicitly codified. But allocation is done largely on the basis of an assessment of needs and it is therefore appropriate to think of it as a means test. Those who qualified were awarded a permanent right to housing at sub-market rents, regardless of future changes in their resources or need.

Clearly, all else equal, the existence of a large and permanent rent subsidy – typically worth thousands of pounds each year – acts to massively increase the financial attractiveness of being in social housing. Hence, all else equal, it strengthens the incentive for those not in social housing to acquire or keep characteristics that increase the chances of gaining access to it (such as having low or no earnings, or having dependent children).

Again, it is important to emphasise here that the scale of the financial incentive does not on its own tell us anything about how much people will *respond* to it. For large numbers of people, this particular incentive is highly unlikely to be relevant for their behaviour: it would often require an extreme change in circumstances to get the all-or-nothing allocation into social housing (particularly in areas where waiting lists are long), making a behavioural response implausible for many. Nevertheless, given the large body of evidence showing that people often do change elements of their behaviour in response to financial incentives (see Section 4.1 for more discussion), it would not be surprising if an incentive of this scale caused some fraction of those affected to alter their behaviour (most likely those close to the 'margin', whose circumstances are not wildly different from those that would be consistent with allocation into social housing). This is an important uncertainty and would be an interesting topic for future research: we are not aware of any large-scale quantitative evidence on the importance of behavioural responses to the social housing means test.

Contrastingly, after one has been allocated social housing, sub-market rents have traditionally had little direct effect on tenants' work incentives – precisely because the means test was not repeated after that point. The fact that existing social tenants' work incentives are not damaged by the direct rent subsidy they receive has long been held out as a key advantage of sub-market rents over HB.

The flip side of this is that there is no guarantee that sub-market rents will continue to be targeted on those with the lowest resources relative to their needs after the point of allocation. We know from previous research by Roantree and Shaw (2014) that people's economic circumstances can change substantially over their lifetimes and that low incomes are often temporary. Social housing providers can take into account a wide range of information when deciding who should be allocated a social property, and this might enable them to distinguish to some extent households that are likely to remain poor permanently from those that are likely to be poor only temporarily. Nevertheless, such foresight will not be perfect. The resources or needs of some social tenants will change in

unanticipated ways, and yet they would continue to get the same direct rent subsidy as before. This would be exacerbated if social tenants respond to the strong incentives provided by sub-market rents[25] to remain within the sector (and indeed within the same property) when they might otherwise have moved out after a change in circumstances or opportunities.

In addition, any such 'immobility' might have effects on employment if social tenants are discouraged from moving to areas where there are more jobs available. Cho and Whitehead (2013) show that social tenants are indeed less likely to move home than other groups, even after controlling for other observed socio-economic characteristics that might affect mobility; though they caution against inferring that the resulting labour market inefficiencies are large, as job-related moves are only a minority of all moves and they tend to involve relatively high-skilled individuals (who are less likely to be social tenants).

HB lies at the other end of the spectrum, in the sense that the level of subsidy received is reassessed almost continuously. The close relationship between HB and current resources means that – in contrast to sub-market rents – households can see their HB withdrawn if their income increases, weakening incentives to increase income through work. The corollary of this is that HB subsidies are, by construction, more closely targeted on those with low current resources relative to need at any point in time than direct rent subsidies provided through social housing. If resources relative to need increase enough, then HB entitlement will automatically be reduced or removed altogether, but direct rent subsidies will not.[26]

The recent direction of reform suggests that the government believes that sub-market rents should be made slightly more similar to HB. First, fixed-term tenancies mean that access to social housing can now be reassessed after the initial allocation for some social tenants, effectively meaning that the means test can be repeated (typically every five years) – though the extent to which social landlords will actually do this is much less clear.[27] Second, 'Pay to Stay' (see Section 2.5) means that the size of the direct rent subsidy can, for the first time, be sensitive to changes in social tenants' income. This targets support more closely on people's current (and probably lifetime) resources relative to need, but it also affects incentives. The reforms make access to social housing less valuable for some tenants (by reducing the size and/or durability of the subsidy that it

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[25] And/or other possible advantages of being in social housing, such as security of tenure.

[26] It is worth noting that, because some low incomes are temporary, HB will be less well targeted on the lifetime poor than on the current poor: some HB will go to people who are not lifetime poor, but who have low incomes now. This has been shown explicitly for means-tested cash benefits in general (rather than HB specifically) in Levell, Roantree and Shaw (2015, figure 2.7). The extent to which social housing is better or worse at targeting the lifetime poor than at targeting the current poor is less clear. It will depend on the details of what criteria different social landlords use to allocate social housing in the first place and on the extent to which these criteria allow them to distinguish between the temporarily and permanently poor.

[27] Shorter-term tenancies could be used as a means of encouraging tenants to treat their property well (instead of, or as well as, a means of continuing to target social housing on the neediest).

entails), which reduces the financial incentive to gain access to social housing in the first place. However, for tenants already in the social sector, the reforms could weaken incentives to work and/or save: increasing their resources might mean that their tenancy is not renewed or that their rent is increased.

This discussion has so far focused on the properties of sub-market rents and HB considered individually. However, two-thirds of social tenants also receive HB, meaning there is an important interaction between these two subsidies: an increase in social rents will not simply reduce the subsidy tenants receive from sub-market rents; it will also increase the subsidy that many receive from HB. This interaction between sub-market rents and HB is central to the analysis that follows.

3.2 Implications of changing social rents

We now turn to the question of what happens when the level of social rents changes, and whether or not these different consequences are desirable. The details here depend on a wide range of other factors, including the way in which social housing is allocated. In principle, policymakers should consider all elements of affordable housing policy together. However, for the purposes of this report, we explore the implications of changing social rent levels taking the wider policy environment as given.

Broadly speaking, the impacts of raising and reducing social rents are symmetric. Notwithstanding the recent decision to reduce social rents in England over a four-year period, the long-term trend has been towards higher rents in the social sector. For illustrative purposes, we therefore discuss the impacts of increasing social rents. The impacts of rent reductions would be the opposite.

Current social tenants' incomes and incentives

An increase in rents in the social sector moves rents closer to the market rate, reducing the direct rent subsidy per social tenant. This has implications for net-of-rent incomes and for incentives, which we analyse and quantify in detail in the next chapter. Here we briefly discuss these impacts qualitatively.

Consider first the effects on household incomes. In the absence of HB, an increase in rents simply reduces all social tenants' incomes after their rents have been paid: that is, it reduces the amount that they can spend on everything other than rent. However, for the two-thirds of social tenants who claim HB (largely the poorest tenants), the interaction between sub-market rents and HB makes the effects very different. An increase in rents will typically have no impact on their net-of-rent income because HB entitlement will increase one-for-one to cover the increase. Exceptions include those subject to the social sector size criteria in HB (commonly known as the 'bedroom tax'), who will normally bear the cost of 14% (and in some cases 25%) of a rent increase, and those for whom the benefit cap is

binding, whose HB cannot rise any further and who will hence face the full cost of a rent increase.[28]

Increasing rents also has implications for social tenants' incentives. It reduces the financial incentive for people to gain access to social housing in the first place and for people to stay in social housing. A notable example of this is that higher social rents increase the incentive for social tenants to exercise their Right to Buy: they make remaining a social tenant less financially attractive (unless a tenant is certain of having their rent fully covered by HB forever), but leave the benefits of purchasing one's home at a discount unchanged.

Increasing rents also affects social tenants' work incentives. This follows directly from the fact that an increase in social rents will make tenants worse off *unless* their income is low enough to claim HB. An increase in rents therefore typically increases tenants' incentives to be entitled to HB, i.e. to keep their income relatively low.

One exception to this rule is for those affected or potentially affected by the overall benefit cap, which applies only to out-of-work families. For families whose benefit income when out of work would exceed the cap, a rent increase would *not* be covered by a rise in HB if out of work – because the benefit cap would prevent their HB from rising – but *could* be at least partly covered if in work because the benefit cap would not apply. Hence the benefit cap means that increases in social rents could actually strengthen the incentive to work for some social tenants when it would otherwise have weakened it.

Changes in social rents may not be uniform across the country. The move toward Affordable Rents is a case in point: as shown by Table 2.2, moving rents to 80% of market rates would be a much bigger change in some areas than others, because social rents as a percentage of market rents currently vary significantly across the country.[29] Tenants who experience a larger increase in rents will of course tend to see larger effects both on incomes and on incentives.

Efficient allocation of social housing

When choosing how to allocate scarce social housing among many applicants, providers will presumably try to allocate it to those who need and value it most (all else equal), but they will not always succeed. A general advantage of markets, which is difficult for social planners to replicate, is that the price mechanism tends to ensure that goods and services are allocated to those who value them most and are willing to pay most for them.

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[28] Raising rents will also mean that some tenants become eligible for HB when they were not before: for this group, HB will cover a portion of an increase in rents.

[29] In particular, while the social rent formula bases rents on a combination of property value and local earnings (see Section 2.5), the Affordable Rent is effectively based solely on the property value (as reflected in the market rent). As such, areas with high property values relative to earnings stand to see the largest increases in rents.

Increasing social rents eases this problem. With higher social rents, there will be less demand for social housing. Those who no longer apply for – or who leave – social housing as a result of higher rents will, almost by definition, be those who value it least (relative to obtaining housing in the private sector). Social housing will therefore be allocated more efficiently, where it is most valued.

Since increasing social rents reduces the incentive to stay in social housing, it reduces the barrier to labour mobility mentioned in Section 3.1: if their rent is less subsidised, people will be more willing to give up their social housing to move to where more jobs are available. This is essentially a particular example of the effect described in the previous paragraph: those who have attractive opportunities to move away to get a job will be among those who value their social housing less highly, and reallocating their social housing towards others in need (while otherwise-similar people for whom moving elsewhere is not a good option are more likely to swallow the rent rise and stay put) is a clear efficiency improvement.

The size of the social housing sector

So far, the discussion of the impact of changing social rents on incomes and incentives has ignored any knock-on effects of increased rental income for social housing providers. In some cases, there are no such effects: for example, additional rental income for local authorities (LAs) as a result of Pay to Stay must be returned to central government. By default, though, money from increased rental income would stay within the social housing sector and there could therefore be knock-on effects on other current or would-be social tenants. The increases in rents allowed under the Affordable Rent scheme, for example, were explicitly introduced as a way of increasing the rental revenue of social housing providers in order to maintain levels of new construction despite cuts to capital grants. The intention was that higher rents would allow the social sector to be larger than it would otherwise have been (taking the capital grant cuts as given), meaning a smaller per-head rent subsidy but a larger total number of beneficiaries.

The eventual impact of changing social rents on the quantity and/or quality of social housing complicates the analysis of the effects of a change in rents on incomes and incentives. In addition to the effects on current tenants, which we have already discussed, more people will ultimately be able to gain access to social housing after a rent increase if providers get to keep the extra rental income and use it to finance more construction. Of course, the amount of additional construction that takes place may be constrained by factors such as planning restrictions and the functioning of the credit market; but it is reasonable to assume some relationship between the income of social landlords and the number of homes they build. In order to understand the overall long-run effects of a rent rise, then, we need to understand the impacts on the incomes and incentives of new potential and actual social tenants.

Thinking first about the impact on incomes, a key question is whether additional social tenants would otherwise be claiming HB in the private sector. If not, then they will benefit from instead being in a social property where their rent is subsidised. If they would have had their private rent fully covered by HB, then there will be no financial gain from instead being in a social rented property. The case where a new social tenant would have had their rent partially covered by HB in the private sector is more complicated.[30]

Turning to the impact on work incentives, broadly speaking an increase in the size of the social housing sector will tend to reduce rents and therefore the importance of HB for the additional social tenants, and thus to strengthen their work incentives. Hence, although higher rents per social property will tend to weaken work incentives for those already in social housing, to the extent that the revenue is used to increase the number of social properties they do not necessarily result in higher average rents – and thus weaker work incentives – across the country as a whole.

It is worth noting that, where additional rental income is not used for construction, it is likely to be used for things that ultimately benefit existing tenants, such as maintenance or management services. Improvements in those kinds of services presumably increase the market rent that could be charged on the property – and hence boost the direct rent subsidy per property. In other words, because social housing providers' budgets are ring-fenced and they are non-profit institutions, additional rental income should ultimately be recycled back into direct rent subsidies (if providers keep the income), whether or not that is by building additional social housing.

Conversely, though, a rent rise might also mean that more LA tenants take up the Right to Buy their property at a discounted price: all else equal, a social rent rise makes this more attractive. In such cases, the mechanical effect is, of course, to make the social housing sector smaller: there is one fewer social home (and one fewer household demanding social housing). In addition, though, there are likely to be important indirect effects on the availability and/or cost of social housing for others.

A sale under Right to Buy will typically worsen LAs' net financial position: revenue from the discounted sale of the property would typically not fully compensate the LA for the loss of future rental income.[31,32] Another way of saying

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[30] The full effects across the country are more complicated still. They will depend on who replaces the new social tenants in the private sector and whether those people are on HB, and on what happens in turn to the housing those people have vacated, and so on. Ultimately, an important part of the story will be what happens to private sector rents as a result of the increased quantity – but increased price – of social housing.

[31] This discussion assumes that the capital value of a property is approximately equal to the present value of the stream of future rental income it will yield, which should be the case in a reasonably well-functioning market.

[32] The percentage Right to Buy discount on the market value of the home is typically larger than the percentage direct subsidy on the market rent received by social tenants. Right to Buy

this is that tenants who take up the Right to Buy are given a gift at that point, equal to the discount they get on the sale price minus the stream of direct rent subsidies that they would otherwise have got as a social tenant. Because LAs' housing budgets are ring-fenced (see Section 2.2), that gift must ultimately be paid for by other social tenants or would-be social tenants. This may happen via reduced levels of new construction, reducing the size of the sector above and beyond the mechanical effect of the Right to Buy sale – meaning that fewer tenants get sub-market rents than would otherwise have been the case. Alternatively, it may happen by reducing the direct rent subsidy per socially-rented property – perhaps by raising social rents further, or perhaps by cutting back on maintenance or management services (which presumably reduces the market rent that would be chargeable on the property, and hence reduces the direct rent subsidy).

It is worth noting that the Office for Budget Responsibility (OBR) assumes that the cut to social rents announced in the July 2015 Budget will act to reduce new construction, at least over the period to 2020–21 (see Section 4.3). Hence it has implicitly assumed that the net effect of a higher rent level is higher construction, despite possible indirect effects on LA finances via take-up of Right to Buy.

Impact on central government expenditure

Raising social rents affects central government spending primarily by increasing the cost of HB. Conversely, reducing social rents will reduce central government spending on HB (which may have been a motivation for the reductions announced in the July 2015 Budget).

In the short term, the effect of a given change in rent levels on HB expenditure depends on the proportion of social tenants who claim HB – currently around two-thirds. Increases in rents will lead to a one-for-one increase in HB for most of this group. However, if additional rents are retained within the social sector and this leads to an increase in the number of social rented properties, then the long-run effects may be smaller: moving more people into social housing, where rents are lower, will tend to reduce the HB bill.

Of course, the government may choose to take other measures alongside an increase in rents which also affect the level of public spending. For example, the Affordable Rent model has increased rental income for certain housing providers, but this has gone hand in hand with substantial cuts in capital grants for new social housing. Similarly, the government plans to require LAs to transfer any increase in rents from higher-income tenants in England under Pay to Stay

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discounts on houses start at 35% after three to five years of tenure, and rise by a further 1 percentage point per year after that (up to a maximum of 70%, or (if lower) £103,900 in London and £77,900 in the rest of England). Proportional discounts on flats are even larger (see https://www.gov.uk/right-to-buy-buying-your-council-home/discounts). The direct rent subsidy in social housing in England, on the other hand, averages about 30% currently (see Table 2.2), though it is likely to rise towards about 40% as social rents are cut by 1% per year in nominal terms for the next four years (as implied by the numbers in Table 4.1, which factors that policy in).

directly to the Treasury (though HAs will be allowed to keep the additional rental income to fund new investment).

Summary

The direct effects of raising social rent levels are as follows: social tenants not on housing benefit are made worse off by the rent increase, while tenants who do receive HB will typically find that it rises to cover the rent increase and hence their income after paying rent is unchanged. Raising social rent levels reduces the large financial incentive to gain access to social housing in the first place, or to stay in it (in particular, it strengthens the incentive for tenants to take up their Right to Buy). However, by increasing the amount of HB going to social tenants, it typically weakens work incentives because HB is means-tested against current income. Raising rents will increase central government expenditure on HB for around two-thirds of existing social tenants – though it will, of course, mean more rental income for social landlords, which central government may or may not choose to recoup from them.

However, there are also important indirect effects of raising rent levels. To the extent that social landlords get to keep the extra rental income and reinvest it in more social housing, sub-market rents will ultimately be extended to more tenants. On the other hand, higher rents may encourage take-up of Right to Buy, which is likely to worsen LAs' financial position and hence may reduce the amount of new investment. The net effect on the size of the sector depends on which of those impacts dominates, but this effect is potentially important. For example, if construction is increased overall, the distributional effect of raising rents in the long run will depend on the characteristics of the 'additional' tenants in the expanded social housing sector, and in particular whether they would otherwise have had their rent covered by HB in the private sector: those who would not will typically be better off as a result of being in subsidised social housing. Similarly, the strengthening of work incentives among people who newly have access to sub-market rents (and who may therefore stand to lose less HB by moving into work) will at least partly offset the weakening of work incentives among existing social tenants.

4. Quantifying the Impacts of Changing Social Rents

Chapter 3 provided a qualitative discussion of the consequences of changing social rent levels. In this chapter, we quantify some of these consequences: the direct effects on tenants' incomes and work incentives and on revenue for the exchequer and social housing providers. As part of this, we illustrate the impacts of two social rent reforms announced in the July 2015 Budget – the 1% nominal reduction in social rents each year for the next four years, and the introduction of 'Pay to Stay', under which higher-income social tenants will pay market or 'near market' rent for their property. We also look at the potential impact if the Affordable Rent model were to become fully embedded in the longer term, with all social rents rising to 80% of market rents. Finally, we show how the introduction of universal credit will change the analysis. All this serves to illustrate the trade-offs around social rent levels, and in particular how those trade-offs depend on the benefit system that is in place.

The chapter proceeds as follows. In Section 4.1, we outline the methodology we use. Section 4.2 quantifies the impact of the system of direct rent subsidies and housing benefit (HB) under current policy plans on rents, incomes and financial work incentives. Section 4.3 looks at the cut in social rents announced in the July 2015 Budget, an increase in social rents to 80% of market rents (as allowed for new tenancies under the Affordable Rent model) and the new Pay to Stay policy. Section 4.4 examines how the introduction of universal credit will alter the impact of changing social rent levels.

Throughout this chapter, we report results for England only. This is because estimates of the market rents of social properties – which are needed for much of the analysis – are not available for the rest of the UK, and because the real-world rent reforms that we analyse apply only in England. We show separate results for London (and, at times, Inner and Outer London[33]) because, as shown in Section 2.5, it has significantly higher rents than the rest of the country and, along with the South East, has the largest direct rent subsidies in the social housing sector. A full regional breakdown of key results is provided in Appendix A.

4.1 Methodology

Household data

We use data from the Family Resources Survey (FRS), a household survey carried out in the United Kingdom that contains detailed information about income,

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[33] Inner London is defined as the following boroughs: Brent, Camden, City of London, Hackney, Hammersmith and Fulham, Haringey, Islington, Kensington and Chelsea, Lambeth, Lewisham, Newham, Southwark, Tower Hamlets, Wandsworth and Westminster.

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household characteristics and rent. We pool the last four years of the FRS, covering the financial years 2010–11 to 2013–14, in order to have a sufficient sample size for all of our analysis. This yields a total sample of 61,259 households in England, of which 11,265 are social tenants and therefore form the basis of the majority of the analysis. Within London, we have a sample of 1,767 social renting households (of which 984 are in Inner London). When looking at the impact of reforms on work incentives, we restrict our analysis to individuals (rather than households) aged between 22 and 59. This gives us a sample of 10,499 individuals in the social rented sector in England (1,861 of them in London, and 1,045 in Inner London), of whom 4,775 are in paid work (827 in London and 475 in Inner London). We use grossing weights supplied with the data to scale up these samples to population totals. Monetary values in the data are uprated to June 2015 terms as appropriate – earnings in line with growth in average earnings, and so on.

The FRS sample is intended to be representative of the household population but, as with all voluntary surveys, not everyone who is asked takes part. The overall response rate over the four years of FRS data we use is 60%, and non-responders are unrepresentative of the population as a whole.[34] The grossing weights will at least partly correct for this, but they may not do so fully, in which case our results may be subject to some unavoidable bias.

Estimates of market rents for social housing

The FRS includes data on rents for both private and social tenants but, in order to estimate the impacts of a given direct rent subsidy, we need to supplement the data with estimates of the market rents that could be charged for the properties in the social sector rented by FRS respondents. Potential market rents for social properties are, of course, not directly observable and there are no current estimates for the whole social housing stock. We therefore draw on Wilcox (2008), who provides separate estimates of average (mean) market rents (and hence the direct rent subsidy) in 2007–08 for social rented properties in England by region, landlord type (local authority or housing association) and number of bedrooms.[35] The key additional assumption we make is that the ratio between actual (subsidised) and market rents in the social sector was unchanged from

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[34] Source: https://www.gov.uk/government/statistics/family-resources-survey-financial-year-201314, https://www.gov.uk/government/statistics/family-resources-survey-2012-to-2013, https://www.gov.uk/government/statistics/family-resources-survey-201112 and https://www.gov.uk/government/statistics/family-resources-survey-201011.

[35] See Wilcox (2008) for details of the methodology used to calculate these estimates. In short, he combines information on the estimated capital values of social sector properties (available for 1999 and updated to 2007–08 levels using regional house price growth) with a net rental yield (derived from the IPD rental index) to derive estimated market rents. Since the estimates are based on the rental yield in the private sector, they are best thought of as estimates of the rent on a given property were it to be privately rented (without any features specific to social housing such as secure tenancy), rather than the market rent for the property were it to remain in the social rented sector.

2007–08 to 2015–16.[36] Although this will not be exact, the evolution of average rents in the private and social sectors since 2007–08 suggests that it is a reasonable approximation for our purposes on average: mean social rents in England increased by 4.9% a year in cash terms (4.3% in London) between 2007–08 and 2013–14, while mean private rents increased by 3.7% a year (3.9% in London). If market rents for social properties have increased at the same rate as private sector rents, this would imply that market and actual social rents have increased at a similar rate too. Of course, this may not hold across all types of property and all places.

While these estimates are, to the best of our knowledge, the best available, they are only approximations. Any error in the estimates will affect our figures for the effect of the existing direct rent subsidy, the effect of increasing social rents to 80% of market rents and the effects of Pay to Stay. Our figures for the effects of a 12% reduction in social rents do not rely on estimates of market rents.

Measuring net incomes

Using the IFS tax and benefit microsimulation model, TAXBEN, we can calculate the benefits and tax credits families are entitled to, and the taxes they are liable to pay, under current, planned and hypothetical tax and benefit systems. Importantly, we can calculate benefit entitlements under different assumptions about the rent that households pay whilst incorporating benefit policies including the benefit cap and the social sector size criteria (the so-called 'bedroom tax').

TAXBEN is a model of entitlements and liabilities, not actual receipts and payments. In effect, therefore, we assume no error or fraud and full take-up of means-tested benefits and tax credits, including HB. Given that in reality 12% of social tenants entitled to HB do not claim it,[37] this will lead us to understate the impact of changes in social rents on net-of-rent incomes (because we will overstate the extent to which those changes are offset by changes to HB entitlements). Alongside our main results we show the effect of changes in the absence of HB, in order to highlight the significance of HB for understanding the consequences of changing rents and in order to illustrate the impact on those who do not take up their entitlement. The reality will be in between the full-take-up and zero-take-up extremes. Note, however, that those who do not claim their entitlements are likely to be different from those who do – in particular, take-up

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[36] To be precise, we estimate market rents as follows. We add to observed social rents the average cash difference between formula rents (see Section 2.5) and market rents, as estimated by Wilcox (2008), for the relevant combination of region, landlord type (local authority or housing association) and number of bedrooms. We then scale rents for social properties to match the average percentage subsidy in the relevant combination of region and landlord type, as estimated bv Wilcox (2008).

[37] Source: Department for Work and Pensions, 'Income-related benefits: estimates of take-up: financial year 2013–14', https://www.gov.uk/government/statistics/income-related-benefits-estimates-of-take-up-financial-year-201314.

rates are lower among those in work and those with smaller entitlements.[38] In addition, benefit reforms and changes to social rents might themselves affect take-up.

All measures of income used here are net of direct taxes and inclusive of benefits and tax credits. For our purposes, it will also be important to capture the effects of rent properly. Changes in rent clearly make tenants better or worse off and this needs to be reflected in the measure of income used. Conversely, changes in HB simply triggered by changes in rent do not necessarily leave the tenant any better or worse off than before, so if HB is included in the income measure then rent needs to be incorporated too.

When simply reporting income levels, as in Table 4.2, we deal with this issue by using a measure of income that subtracts rent. This gives numbers that are easily interpreted: namely, the amount of income available to spend on things other than rent. Elsewhere in the chapter, underlying the detailed analysis of the distributional and work incentive impacts of social rent policy, we use a slightly different measure of income. Rather than *subtracting* rent from income, we *add* the value of the direct rent subsidy received by social renting households. The two approaches will give identical answers to the question of how income changes when rent changes. But the latter will give social renting households a higher level of income than the former. This is appropriate: it reflects the fact that the direct rent subsidy received by social tenants increases their living standards, giving them more to spend on things other than rent (or the opportunity to live in more valuable housing than they otherwise could, given spending on other things). In effect, the direct rent subsidy is a 'benefit in kind' provided to social tenants and we treat it as such. It means that subsidies provided through HB and through a direct rent subsidy are treated consistently – both are added to income. Simply switching the form of subsidy from one to the other would have no effect on income levels.

Measuring financial work incentives

Financial work incentives depend on the relationship between hours of work and net income. Thus they will depend on both the gross earnings that an individual can obtain in work and their tax liabilities, benefit entitlements and rents at different levels of earnings.[39]

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[38] Source: Department for Work and Pensions, 'Income-related benefits: estimates of take-up: financial year 2013–14', https://www.gov.uk/government/statistics/income-related-benefits-estimates-of-take-up-financial-year-201314. Since expenditure take-up is higher than caseload take-up, one can infer that take-up rates are lower for those with smaller entitlements.

[39] We restrict our analysis to direct personal taxes (including employer National Insurance contributions), cash benefits and social rent levels. Other work by IFS researchers (for example, Adam and Browne (2013)) has also included the effect of indirect taxes on work incentives. However, since the FRS does not have data on household expenditure and we are not looking at reforms to indirect taxes, we exclude indirect taxes. This will affect the absolute levels of estimated incentives but not the patterns.

Individuals clearly have financial considerations other than their tax liabilities and benefit entitlements when deciding whether and how much to work (for example, childcare and commuting costs, and potentially costs associated with not working such as heating one's home), but we do not have sufficient information on these in our data to incorporate them in our analysis.

Of course, people may also take into account many non-financial considerations, and indeed these may be at least as important in explaining people's choices as financial considerations. In this report, though, we are looking specifically at the policy choice over social rent levels: we are asking what happens if one changes rents whilst holding constant all other factors (therefore including, by construction, all non-financial factors). Hence the changes in incentives that are relevant here are changes in financial incentives.

It is important to distinguish between the scale of an incentive and how much people's behaviour *responds* to the incentive. For example, the financial incentive to be in work is simply a matter of arithmetic, obtained by comparing the financial position of an individual if they work with their financial position if they do not. But not everyone is equally responsive to the same incentive, and some people may not respond at all (for example, those with a health problem that prevents them from working). In the case of work incentives, there is a large academic literature estimating how much people's work behaviour responds to them.[40] We know, for example, that the employment decisions of women with school-age children and of people around retirement age are relatively responsive to financial incentives, whereas the hours of work of 25- to 50-year-old men barely respond at all. In this report, we do not attempt to estimate or predict such behavioural responses – merely to discuss and quantify the effects of policies on incentives to which people *might* respond.

We distinguish between the financial incentive to be in work at all (as opposed to not working) and the incentive for those in work to increase their earnings slightly – whether by working more hours, seeking promotion or moving to a better-paid job.

We measure the incentive to work at all by the replacement rate (RR), an individual's income if they did not work as a proportion of their in-work income, and the participation tax rate (PTR), the proportion of total earnings taken in tax and withdrawn benefits. That is:

$$RR = \frac{Net\ income\ out\ of\ work}{Net\ income\ in\ work}$$

$$PTR = 1 - \frac{Net\ income\ in\ work - Net\ income\ out\ of\ work}{Gross\ earnings}$$

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[40] See, for example, Blundell and MaCurdy (1999), Meghir and Phillips (2010), Bargain, Orsini and Peichl (2011) and Keane (2011) for reviews.

Box 4.1. Estimating the potential earnings of non-workers

Our approach to estimating the potential earnings of non-workers involves a number of steps:

1. We first estimate a simple (ordinary least squares) model of log earnings for each of four weekly hours-of-work bands (0–15, 16–23, 24–29 and 30+) using working individuals in our sample of interest (22- to 59-year-old social tenants) observed in the relevant hours category in the FRS data.[a] Characteristics that we use to explain earnings include age, sex, education, marital status and age of youngest child.

2. We use the estimated relationship between these characteristics and earnings to predict the earnings that non-workers would get if they were to work in each of the above hours bands. Since most of the variation in earnings is not explained by the characteristics in our model, we add an error term to each prediction, drawn at random from the residuals from the relevant regression. This ensures that we preserve the variation in earnings between workers with similar observed characteristics. We then calculate a hypothetical RR and PTR for each individual were they to choose to work that number of hours.

3. We use a multinomial logit model to estimate the probability of each non-working individual choosing to locate in each hours band (conditional on choosing to work at all), again using the observed choices and characteristics of the workers in our sample of interest.

4. We create a final estimated RR and PTR for each non-worker by taking a weighted average of the RRs and PTRs estimated in step 2, with the weights being the estimated probability of locating in each hours band from step 3.

The most significant limitation of this approach is that we do not account for the fact that potential earnings in work are an important determinant of whether to work. Given this, one would expect the potential earnings of someone not working to be lower than the earnings of an individual in work with the same observed characteristics. While there are 'selection corrections' that attempt to overcome the bias arising from this, they require either making strong (and in our view unjustifiable) assumptions about the precise relationship between an individual's wage rate and the hours they decide to work or else finding some observed factor that predicts whether an individual is employed in the relevant hours band but can be assumed not to predict what they could earn by working those hours (we can find no plausible candidates for such a factor). We therefore do not attempt to implement such a correction, and so are likely to overestimate potential earnings for non-workers. This will lead us to understate their RRs (effects on PTRs are ambiguous).

[a] When estimating the potential earnings of non-working private tenants, our sample of interest is, of course, 22- to 59-year-old private tenants.

We measure the financial incentive for individuals who are already in work to increase their earnings using the effective marginal tax rate (EMTR), the proportion of a small increase in earnings taken in tax and withdrawn benefits. We calculate EMTRs by increasing individuals' gross earnings by one penny a week (leaving their hours of work unchanged) and seeing what would happen to their net income.[41] For all measures, higher numbers mean weaker work incentives.

When calculating these measures for people with more than one adult in the household, we look at the relationship between an individual's working behaviour and their household's net income, holding constant the work choices of other household members. The implicit assumption is that household members fully pool their income – not a wholly realistic assumption, but alternative extreme scenarios seem even less plausible and modelling truly realistic within-household allocations would be very difficult.

For a given level of gross earnings, the PTR depends on the difference between in- and out-of-work incomes while the RR is the ratio between them. This gives them different properties. A reform that changes in- and out-of-work incomes by the same cash amount, leaving the absolute difference between them the same as before, will affect RRs but not PTRs. Conversely, a reform that changes in-work and out-of-work incomes by the same proportion (different cash amounts) will affect PTRs but have no effect on RRs.

By combining the information on household characteristics contained in the FRS with TAXBEN, it is relatively straightforward for us to calculate out-of-work income for individuals who are observed in work in the data. By comparing this out-of-work income (for example, total benefit entitlements plus any partner's net earnings) with their actual net income, we can calculate RRs and PTRs for workers. For non-working individuals, however, it is necessary to estimate what they would earn if they were to move into work, in order to calculate their RR and PTR. Technical details of the estimation procedure can be found in Box 4.1.

4.2 The impact of rent subsidies on incomes and work incentives

Before looking at the impact of changes in social rent levels on the incomes and work incentives of social tenants, it helps to understand the impact of the overall system of direct rent subsidies on those outcomes.

The system of taxes, benefits and social rents that we analyse in this section is a variant of the current (2015–16) system, in which we treat reforms due to be

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[41] When calculating PTRs and EMTRs, we include employer National Insurance contributions (NICs) in our measure of gross earnings (which might therefore be more accurately termed 'labour cost').

implemented in the coming years as if they were in place now,[42] with two exceptions. First, we do not incorporate the introduction of the new 'Pay to Stay' policy, because its details have yet to be finalised – instead, we analyse some of the ways in which this could be implemented separately in Section 4.3. Second, we do not include universal credit, which the government plans to roll out gradually over the course of this parliament. It is arguably easier to understand the interaction between social rents and the benefit system in the more familiar context of HB, and then to look at how the introduction of universal credit will change the analysis. The consequences of introducing universal credit are therefore analysed separately in Section 4.4 (and Appendices B and C).

As discussed in Chapter 3, the two ways in which social tenants receive support for rents are through HB and sub-market rents. We quantify the effect of these two forms of subsidy by showing the net rents (i.e. rents minus HB), incomes and work incentives of social tenants in four alternative scenarios: market rents and no HB (neither subsidy in place), social rents but no HB, market rents with HB, and finally the current real-world system with both sub-market rents and HB.

Table 4.1 shows mean net rents for working and non-working households, in London and in the whole of England, in these four scenarios.[43] Hence:

- Comparing columns (1) and (2) shows that the effect of sub-market rents alone (without HB) would be to reduce rents substantially (by almost 40% at the mean), and by similar amounts for both working and non-working households, but by more in London than in the rest of England (£83 rather than £51 on average). Recall that this is after factoring in a 12% cut in social rents, to reflect the impact of the July 2015 Budget announcement.

- Comparing columns (1) and (3), we see that HB alone would reduce net rents by even more, and as a means-tested benefit HB reduces rent by much more for non-working households than for working households on average.

- Comparing columns (3) and (4) shows that, in the presence of HB, sub-market rents reduce net rents by much less than they otherwise would, and they benefit working households more than non-working households. This is because, for many claimants, lower rents simply trigger lower HB entitlements, leaving net rents unchanged; but this is less common for working households because they are less likely to be entitled to HB. Looking at England as a whole, direct rent subsidies reduce overall mean net rent by only £14 a week, but among working households that figure is £27 a week.

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[42] By 'reform' we mean any change due to be implemented after April 2015 relative to what the government's public finance forecasts in April 2015 assumed would happen. In the case of social rents, the default until 2024–25 was for them to grow in line with CPI inflation plus 1% per year. As already stated, the policy of reducing them by 1% per year for four years will ultimately represent a 12% cut relative to that previous default (under current inflation forecasts). Hence we model social rent levels as being 12% below their 2015–16 levels.

[43] These figures are different from those in Table 2.2 as they incorporate the cuts to social rents planned to be in place by April 2019.

Table 4.1. Mean weekly rent net of housing benefit for households in the social rented sector under different rent subsidy systems

	(1) Market rents, no HB	(2) Social rents, no HB	(3) Market rents, HB	(4) Social rents, HB
England	£136	£85	£48	£34
Working households	£145	£88	£92	£65
Non-working households	£131	£82	£21	£15
London	£191	£108	£62	£42
Working households	£200	£114	£114	£77
Non-working households	£184	£104	£23	£15

Note: Calculations based on the system of taxes, benefits and social rents described on page 40, and estimates of market rents based on Wilcox (2008). Figures given in 2015 prices.
Source: Authors' calculations using Wilcox (2008) and TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

All this serves to highlight that it is crucial to understand how direct rent subsidies and HB interact with each other, rather than thinking about each in isolation.

Table 4.2 shows the impact of sub-market rents and HB on weekly incomes net of rent for social tenants, in the same four scenarios. Perhaps the most striking result is how sub-market rents and HB change the relationship between the net-of-rent incomes of social tenants in London and those in the rest of England. In the scenario with market rents and no HB, mean household net-of-rent income

Table 4.2. Mean weekly household income net of rent for households in the social rented sector under different rent subsidy systems

	(1) Market rents, no HB	(2) Social rents, no HB	(3) Market rents, HB	(4) Social rents, HB
England	£188	£240	£276	£290
Working households	£317	£373	£370	£396
Non-working households	£108	£156	£217	£223
London	£161	£244	£290	£310
Working households	£322	£408	£408	£444
Non-working households	£38	£118	£199	£207

Note: Calculations based on the system of taxes, benefits and social rents described on page 40, and estimates of market rents based on Wilcox (2008). Figures given in 2015 prices.
Source: Authors' calculations using Wilcox (2008) and TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

among social tenants is nearly £30 a week lower in London than in England as a whole. However, after the effects of sub-market rents and HB, mean net-of-rent income is £20 a week higher in London than in England as a whole.

Table 4.3 shows our three measures of average financial work incentives in each scenario. Here we restrict our sample to adults between the ages of 22 and 59 inclusive.[44] Again we look at work incentives for social tenants in the four different scenarios, with the work incentives of tenants in the private rented sector also shown for context.

- Comparing columns (1) and (2), we see that, in the absence of HB, PTRs and EMTRs are unaffected by the direct rent subsidy. This simply reflects the fact that the direct subsidy is not means-tested against current income, so the absolute net income gain from increasing earnings is insensitive to the rent subsidy. However, this does not necessarily mean that the direct rent subsidy would have no effect on work incentives. Giving people a subsidy that is the same regardless of whether they are in work acts to reduce the *proportionate* difference between how well off they are when in work and when out of work. We might reasonably think of this as a weakening of their incentive to work. The RR captures this because it is sensitive not just to differences between in-work and out-of-work income, but also to their absolute levels. We are including the 'benefit-in-kind' of a direct rent subsidy in our definition of income (see Section 4.1), and the value of that benefit does not change when an individual changes work status. Hence, RRs increase as a result of this subsidy. As one would expect, the bigger direct rent subsidy in London means this increase is larger there (6.2 percentage points) than in England on average (4.2ppts).

- The difference between columns (1) and (3) – shown explicitly in the penultimate column – reveals the impact of HB on work incentives if there were no direct rent subsidies. The existence of HB, while increasing the incomes of many social tenants, significantly weakens their incentive to be in work. This is because, as a means-tested benefit, HB increases out-of-work incomes relative to in-work incomes, raising RRs and PTRs. HB also weakens the incentives for some of those in work to increase their earnings, because they lose some of their additional earnings in reduced HB entitlement (increasing EMTRs).

- The difference between columns (3) and (4) – shown explicitly in the final column – reveals the impact of direct rent subsidies given the presence of HB. On all three measures, the direct rent subsidy given to social tenants strengthens their work incentives on average. The mean PTR among social tenants in England falls by 3.1ppts (2.8ppts in London) and the mean EMTR for working social tenants in England falls by 4.6ppts (with the same fall in

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[44] We exclude younger adults since their choice may be between work and education. We exclude older adults because we have insufficient information on their private pension entitlements to calculate their income were they to leave work and start claiming a pension.

Table 4.3. Financial work incentives for individuals aged 22–59 in the social rented sector under different rent subsidy systems (April 2019)

	(1) Market rents, no HB	(2) Social rents, no HB	(3) Market rents, HB	(4) Social rents, HB	*Memo:* private rented sector (with HB)	Impact of HB, given market rents (3 − 1)	Impact of sub-market rents, given HB (4 − 3)
Mean RR							
England	63.1	67.3	76.9	75.9	62.8	+13.8	−1.0
London	61.7	67.9	78.0	77.0	62.5	+16.3	−1.0
Mean PTR							
England	42.3	42.3	56.9	53.8	42.5	+14.6	−3.1
London	42.1	42.1	57.0	54.1	42.6	+14.9	−2.8
Mean EMTR among workers							
England	43.3	43.3	55.1	50.5	45.4	+11.9	−4.6
London	42.5	42.5	55.7	51.1	45.5	+13.1	−4.6

Note: Calculations based on the system of taxes, benefits and social rents described on page 40, and estimates of market rents based on Wilcox (2008). Incomes include the imputed value of the direct rent subsidy.

Source: Authors' calculations using Wilcox (2008) and TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

London). The impact of sub-market rents on RRs is smaller, reducing them by only 1.0ppts on average in both London and England as a whole. This in part reflects the fact that for those not entitled to HB when in work or out of work (mostly those with a working partner), sub-market rents increase RRs, by raising both in- and out-of-work incomes by the same amount and hence reducing the proportionate difference between them.

In summary, as discussed qualitatively in Chapter 3, sub-market rents tend to strengthen the work incentives of social tenants on average. This is because they reduce entitlements to HB, and HB itself tends to weaken work incentives.

It is also noteworthy from Table 4.3 that average financial work incentives are similar in London to those in England as a whole. The (potential) earnings of social tenants are higher in London, strengthening work incentives, but, offsetting that, higher rents and hence higher HB entitlements weaken work incentives.

It is worth remembering that, while social rent subsidies strengthen the work incentives of existing social tenants on average, they also strengthen the incentive for those who are not currently social tenants to acquire or keep characteristics that increase the chances of gaining access to social housing (as lower social rents make being a social tenant more valuable). Since having low or no earnings might increase an individual's chance of being allocated social housing, lower social rents may weaken the work incentives of those not currently in social housing. This issue was discussed in Section 3.2.

Work incentives and the benefit cap

One new feature of the tax and benefit system (incorporated in the results above) that has important consequences for the work incentives of social tenants, and the work incentive effects of changing social rents, is the overall family benefit cap. Since 2013, the total amount of benefits that most non-working families in which no one is disabled can receive has been capped at £26,000 a year; from April 2016, the cap will be reduced to £23,000 a year in London and £20,000 a year in the rest of Great Britain (the levels used in our analysis).[45] The cap reduces the incomes of a relatively small number of social renting households (an estimated 30,000 households in England under the new lower cap, compared with the 10,000 previously capped[46]) but it affects the work incentives of a wider group. In particular, as well as the 30,000 non-working households whose benefits are reduced by the cap (at its new level), we estimate that a further

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[45] There are exemptions for war widows and widowers, families in receipt of disability living allowance (DLA), personal independence payment (PIP), the support component of employment and support allowance (ESA), an industrial injuries benefit or working tax credit, and those on universal credit whose family earnings exceed £430 per month. The cap also does not apply for 39 weeks after the end of an employment spell if that spell lasted for at least one year. The new lower benefit cap will be £13,400 for single adults without children (£15,410 in London).

[46] 30,000 is our estimate; 10,000 is from DWP Stat-Xplore, accessed 2 November 2015.

70,000 working households *would* find that the benefit cap reduced their income if they were out of work – hence their work incentives are strengthened by the cap.[47]

The benefit cap does little to alter the effect of direct rent subsidies on incomes, but it has more widespread effects on the way that direct rent subsidies impact on work incentives. For individuals in families whose benefits are capped – or would be capped if they were out of work – the direct rent subsidy can actually *weaken* the incentive to be in work. This is because for capped individuals (unlike most other tenants), HB does not cover all of their rent, and so the direct rent subsidy increases out-of-work incomes (net of rent). On the other hand, since the cap does not apply to those in work, the direct rent subsidy increases their in-work income only if they earn too much to be entitled to HB (otherwise HB just falls along with rent). Appendix Table A.1 shows that these effects are quantitatively important. Without any benefit cap, sub-market rents reduce the mean RR for social tenants in England by 1.5ppts and their mean PTR by 4.3ppts. With the new lower benefit cap, some people actually have their work incentives weakened by direct rent subsidies, so the average strengthening of work incentives is smaller: a reduction of just 1.0ppts in the mean RR and of 3.1ppts in the mean PTR.

4.3 The impact of changing social rent levels

In this section we quantify some of the impacts of changing the level of social rents. In doing this, we shed light on the impacts of specific recent or imminent changes to social rent policy described in Chapter 2, and on important differences between the different reforms.

We first look at the impact of the decision made in the July 2015 Budget to reduce all social rents in England by 1% a year in cash terms for four years from April 2016. This amounts to an expected 12% reduction in social rents by 2019–20 relative to the previous plan of increasing them by CPI inflation + 1% per year. We then estimate the impact of increasing all social rents to 80% of market rents, the level permitted for new tenancies under the recently-introduced Affordable Rent model (see Section 2.5), to give a sense of its potential impacts in the long run. This policy implies a larger rise in rents where the direct rent subsidy is currently larger. We then turn our attention to a reform that changes the structure of social rents in yet another way: namely, the so-called 'Pay to Stay' reform announced in the July 2015 Budget, under which higher-income social tenants will pay market or 'near market' rents for their properties. Since the details of this policy are yet to be decided, we illustrate and evaluate some different options.

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[47] Given the small number of families involved, this estimate has a larger-than-usual margin of error associated with it.

12% uniform reduction in social rents

In the July 2015 Budget, the government announced that social rents in England will be cut in cash terms by 1% a year from 2016–17 to 2019–20 inclusive, rather than rising by CPI inflation + 1% each year as previously planned. Given Office for Budget Responsibility (OBR) forecasts for the CPI, this amounts to an expected 12% cut to the level of social rents in 2019–20 relative to previous plans.

We estimate that this uniform 12% reduction in social rent levels will reduce the rents paid by 3.9 million social renting households in England by an average of £600 per year. That implies a total reduction in rental income for social landlords (or, equivalently, a total increase in the direct rent subsidy to tenants) of £2.3 billion a year (in 2015–16 prices). Of that, £1.3 billion comes from housing associations and the remaining £1.0 billion from local authorities.

Although our quantitative analysis focuses on tenants' net-of-rent incomes and work incentives, it is important to note that a £2.3 billion reduction in the annual income of social landlords could have significant effects on the amount of new housing supply, as pointed out by various commentators and social landlords.[48] The OBR assumes that the policy will reduce the number of social sector properties built between now and 2020–21 by about 14,000 (and that this will not be offset by greater private sector construction 'to any material degree').[49] Ultimately, then, the increase in the direct rent subsidy going to existing social tenants should be seen alongside a likely reduction in the number of households that will benefit from subsidised social rents in future. In addition, the announcement does little to instil confidence in the future stability of social rent policy, coming as it did after just one year of increasing rents by CPI + 1% – despite the coalition government saying that the CPI + 1% policy would apply for 10 years, with the stated aim of providing certainty. Undermining such certainty risks doing damage to the ability of social landlords to plan their investments, or to secure finance for those investments at low cost, given the potential increase in perceived risk around their level of future rental income.

Most of the reduction in social rents will not translate into an increase in the net-of-rent incomes of existing social tenants, because much of their rent is covered by HB anyway. Hence the policy largely represents a transfer from social landlords to the exchequer rather than to social tenants. Assuming full take-up of HB, we estimate that the £2.3 billion in reduced rental income for social landlords breaks down into reduced HB spending by the exchequer of about £1.7 billion[50] and increased net-of-rent incomes for social tenants of £0.7 billion (with around

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[48] Wilson (2015b) collects and summarises the arguments.

[49] Office for Budget Responsibility, 2015, para. 3.84.

[50] This compares with the government's own estimate of £1.8 billion (in 2015 prices) in HM Treasury (2015b).

1.6 million social renting households gaining by an average of £420 per year).[51] Regional results are in Appendix Table A.2.

Averaged across all households in England (not just social tenants), the gain is £30 a year on average, or 0.1% of income. Figure 4.1 shows how this varies across the income distribution. Showing the average gain across the whole population allows us to account for where social tenants are in the overall income distribution as well as how the gains vary within the group of social tenants. Assuming full take-up of HB, the cash gain is largest in the middle of the income distribution, at around £40 a year. Gains are smaller towards the bottom of the distribution because households in that part of the distribution are more likely to have their rent covered by HB, and they are smaller towards the top of the distribution because there are fewer social renting households in that part. When expressed as a percentage of income, the relative gains look larger towards the bottom, but the same broad distributional pattern remains.

Figure 4.1 also shows the impact of a 12% reduction in social rents in the absence of HB, to give a sense of the potential impact of non-take-up of HB and to

Figure 4.1. Impact of a 12% reduction in social rent levels by overall income decile
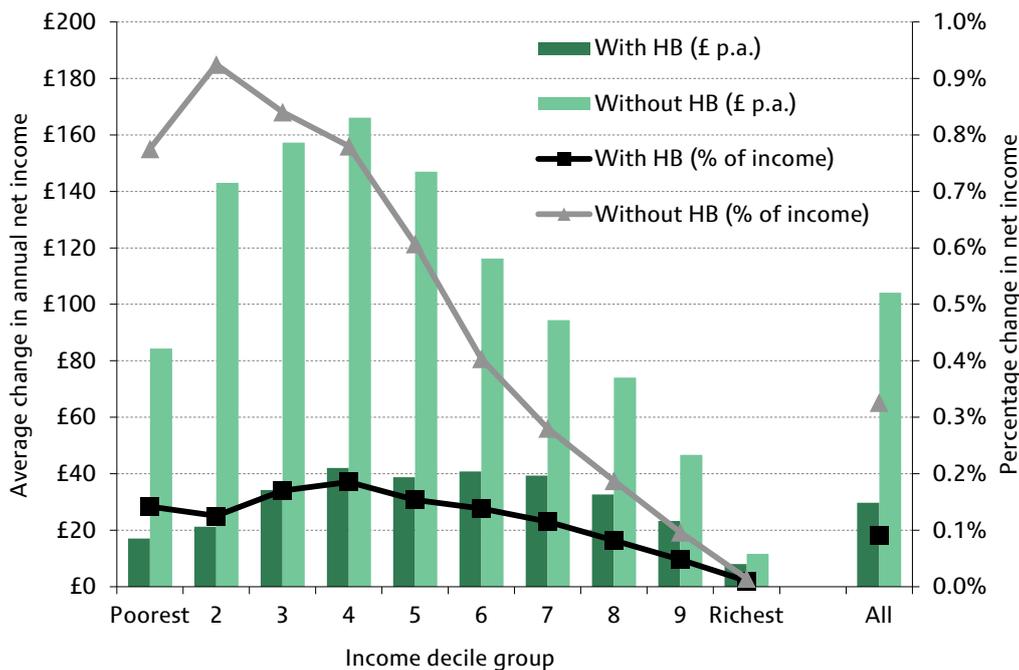
Note: Sample is all households in England. Income decile groups are derived by dividing all households into 10 equal-sized groups according to income (including housing benefit and the imputed value of any social rent subsidy) adjusted for household size using the McClements equivalence scale.
Source: Authors' calculations using TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

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[51] Of the 1.5 million social renting households with someone in work, 1.0 million gain.

highlight how important the interactions between rent and HB are. In the absence of HB, gains from social rent reductions would be much larger and also more concentrated towards the bottom of the income distribution. Groups benefiting from social rent reductions will in practice include low-income tenants who are not claiming their entitlement to HB as well as higher-income tenants not entitled to it.

Table 4.4 shows the effect of this 12% reduction in social rents on the financial work incentives of social tenants. We show results separately for London (also splitting Inner and Outer London) and by family type. Results for each English region are shown in Appendix Table A.3. Alongside the three summary measures of work incentives discussed in Section 4.1, we also report the impact of the reform on the proportion of working individuals whose household receives some HB. This captures the impact of changing social rents on how far HB entitlement spreads up the income distribution.

As one would expect, the 12% cut in social rents strengthens average incentives to be in work, reducing the average RR by 0.3ppts and the average PTR by 0.9ppts. In the case of PTRs, this is quite a large impact relative to the limited effects of the policy on incomes and on government revenue: for context, a 1 percentage point cut to all rates of income tax would reduce the mean PTR among social tenants by 0.2ppts. The average effect of the reform in reducing RRs and PTRs is slightly smaller in London than in the rest of England.

The bottom panel of Table 4.4 emphasises further that the work incentive effects of rent changes are complex. There are clear differences in how the 12% reduction in rents affects the incentives for people in different kinds of family to be in work. The biggest average falls in RRs and PTRs are for single individuals without children, those in couples with a non-working partner and no children, and those with a working partner and children. This reflects the fact that these are individuals for whom a decision to work is relatively likely to increase household income above the point where they are entitled to any HB. Their net-of-rent income when in work therefore depends on how high their rent is (because it is not covered by HB), while their net-of-rent income when out of work does not (because rent is then covered by HB). Hence, reducing rent strengthens the incentive to work.

In contrast, other groups will on average see the rent reduction weaken their incentive to be in work, or at least strengthen it less. These include those with a working partner and no children, and those with a non-working partner and with children. In the first case, this reflects the fact that such households tend to have little if any HB to lose when a second adult moves into work, because the first earner's earnings have already reduced or exhausted HB entitlement. Hence the role of HB in meaning that lower rents translate into stronger work incentives is less significant for them. In the second case, it largely reflects the impacts of the benefit cap (the cap is particularly likely to affect workless households with children), which was discussed in Section 4.2.

Table 4.4. The effect of reducing social rents by 12% on the work incentives of social tenants

	Individuals (millions)	Mean RR			Mean PTR			Workers (millions)	Mean EMTR among workers			% of workers on HB		
		Before	After	Change	Before	After	Change		Before	After	Change	Before	After	Change
England	3.9	76.2	75.9	–0.3	54.7	53.8	–0.9	1.8	51.5	50.5	–0.9	39.3	35.7	–3.6
London	0.8	77.2	77.0	–0.2	54.8	54.1	–0.7	0.4	52.2	51.1	–1.1	46.3	42.3	–3.9
Inner London	0.5	76.4	76.2	–0.2	54.7	54.1	–0.6	0.2	51.9	50.7	–1.1	47.6	43.6	–4.0
Outer London	0.3	78.4	78.1	–0.3	55.0	54.2	–0.7	0.2	52.6	51.7	–1.0	44.2	40.4	–3.8
Rest of England	3.1	76.0	75.6	–0.3	54.7	53.7	–1.0	1.4	51.3	50.4	–0.9	37.5	33.9	–3.6
Single without children	1.4	71.5	71.1	–0.5	56.4	55.3	–1.1	0.6	42.5	41.8	–0.8	31.4	27.5	–3.9
Couple without children, partner not in work	0.3	79.9	79.4	–0.5	66.9	65.6	–1.2	0.1	53.4	52.6	–0.8	33.4	32.2	–1.1
Couple without children, partner in work	0.4	64.3	64.3	+0.0	26.3	25.3	–1.0	0.3	34.9	34.2	–0.7	3.4	2.3	–1.1
Lone parent	0.6	80.2	80.1	–0.1	48.9	48.7	–0.2	0.2	79.5	78.6	–0.9	80.5	75.6	–4.9
Couple with children, partner not in work	0.6	85.5	85.6	+0.1	73.4	73.8	+0.4	0.3	68.1	67.2	–0.9	79.4	75.1	–4.3
Couple with children, partner in work	0.6	78.8	78.2	–0.6	49.0	46.6	–2.3	0.4	46.5	44.9	–1.6	23.7	19.2	–4.5

Note: Sample is individuals aged 22–59. Calculations based on the system of taxes, benefits and social rents described on page 40. Incomes include imputed value of direct rent subsidy.

Source: Authors' calculations using TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

Turning to the impact of the rent cut on the incentive for those in work to increase their earnings, the mean EMTR faced by working social tenants falls by 0.9ppts. Again this is a relatively large impact – a 1 percentage point cut to all rates of income tax would reduce the mean EMTR among working social tenants by 0.6ppts. Average EMTRs fall because, with lower rents, fewer people are entitled to HB and face having it reduced as they increase their earnings. Among all 22- to 59-year-old social tenants in work, the proportion receiving some HB falls from 39.3% to 35.7%.

Increasing social rents to 80% of market rents

The announcement in the July 2015 Budget that social rents would fall by 1% a year in cash terms for four years from 2016–17 represented a reversal of the previous trend in government policy to allow increases in social rents – including the policy of the previous coalition government. A major plank of social housing policy under the coalition was the introduction of a new so-called 'Affordable Rent' tenure, introduced in 2011 (see Section 2.5). Despite the name, this policy allows for higher rents in the social sector, of up to 80% of market levels. It remains in place and applies to new lettings where the social landlord agrees to use the additional rental income to help finance extra housing supply.

Here we look at the impact on existing social tenants' rents, incomes and work incentives of an increase in all social rents to 80% of the estimated market rent for the property.[52] This is not a realistic scenario in the short term, but serves to illustrate some of the consequences of allowing the Affordable Rent model to become fully embedded in the long term.

Of course, any increase in housing supply associated with the expansion of the Affordable Rent model would also have much wider effects (see Section 3.2 for detailed discussion). Including a 12% cut to social rents in our baseline (reflecting the July 2015 Budget announcement), we estimate that an increase to 80% of market rents would increase the total rental income received by social landlords by around £5 billion a year (almost 30%) in 2015 prices. Clearly, that could have a significant impact on the amounts of new social housing construction that could be financed and hence, ultimately, the number of people who can benefit from subsidised rents in the social sector. More housing supply could also have important impacts on the wider economy.

The £5 billion total annual increase in rents from a move to 80% of market rents equates to an average increase of £1,290 a year per social renting household. Around £3 billion would go to housing associations, with the remainder going to local authorities. Most of the increase in rental income would come at the expense of the exchequer – the estimated increase in annual HB spending is £3.6 billion. The remaining £1.4 billion would come from about 1.6 million social

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renting households that are not on HB, which would on average lose about £890 a year.

An important difference between this policy and the policy analysed in the previous subsection is that the percentage change in rent varies across social renting households. Across England, social rents increase by 30% on average. But, as one would expect given the larger percentage subsidies in London and the South East (see Table 2.2), that figure varies by region: 41% for London and only 14% for the North East. The quarter of a million households in London that would see their incomes fall would lose an average of £1,600 a year, compared with just £317 a year for those affected in the North East. Results for all English regions are in Appendix Table A.4. But even within regions – indeed, even among households of in specific locations – increasing social rents to 80% of market rents could have widely varying effects for individual households, reflecting in large part the wide variation in current subsidies as a percentage of market rents across properties of different sizes (see Section 2.5 for more details).

Figure 4.2 shows the distributional impact of increasing social rents to 80% of market rents, with and without HB. Again, the definition of income includes the direct rent subsidy received by social tenants (which is reduced by this policy). With HB in place, the average cash losses are largest (between £80 and £90 a

Figure 4.2. Impact of increasing social rents to 80% of market rents by income decile
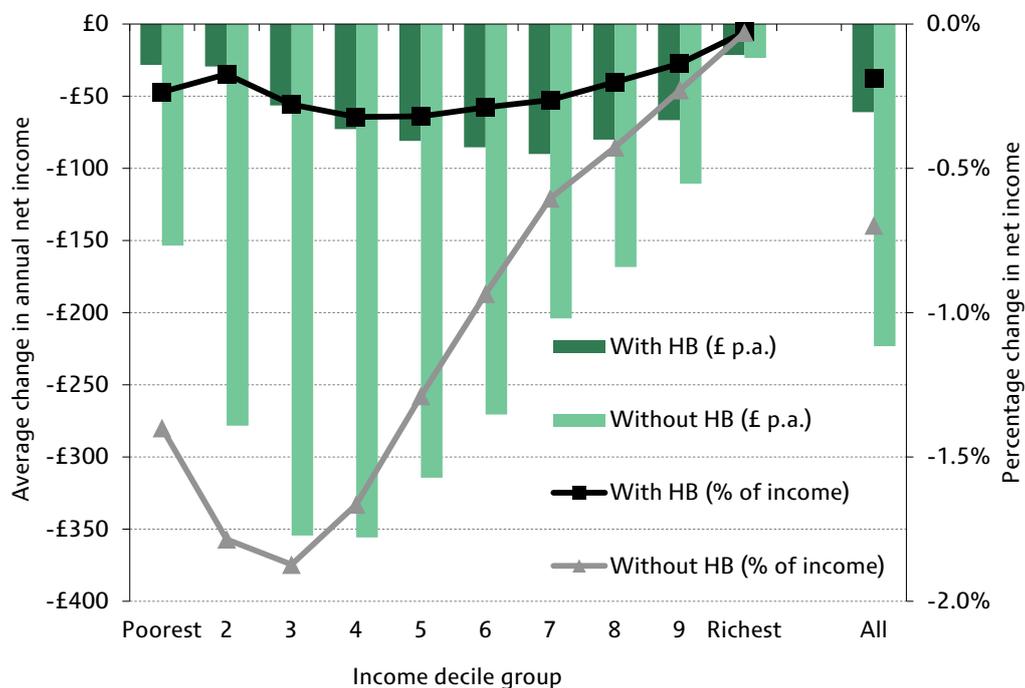
Note: Sample is all households in England. Income decile groups are derived by dividing all households into 10 equal-sized groups according to income (including housing benefit and the imputed value of any social rent subsidy) adjusted for household size using the McClements equivalence scale.
Source: Authors' calculations using TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

year) in the upper-middle of the distribution, while as a percentage of income the losses are largest across the middle of the distribution. Again, impacts lower down the distribution are smaller on average because HB is more likely to cover rent rises. The impact is more focused towards the top of the distribution than a uniform change in social rents (shown in Figure 4.1). This reflects the fact that those currently enjoying the largest proportional rent subsidies – who stand to lose most from this policy – are further up the distribution than average (given that their incomes here include the value of the direct rent subsidy they receive).

Without HB, the cash losses from increasing social rents to 80% of market rents would be largest in the lower-middle of the income distribution, at over £300 a year on average in the third to fifth deciles.

Table 4.5 illustrates the effect of increasing social rents to 80% of market rents on the work incentives of social tenants. As discussed in Chapter 3, the rent increase would tend to weaken work incentives, both to be in work at all and to increase earnings if in work. The mean RR among social tenants increases by 0.7ppts, the mean PTR by 1.9ppts and the mean EMTR by 2.2ppts.

To some extent, we see here the opposite patterns of the effects of the rent *decrease* analysed in the previous subsection. The interesting differences relate to the relative effects of the rent change on different groups, because the percentage rent increase under the Affordable Rent model can vary across households.

For example, focusing on the incentive to be in work at all, one might expect this reform to have a larger effect on households in London than the uniform rent change analysed before (given the disproportionate impact of increasing social rents to 80% of market rents on rents in London). Table 4.5 shows that this is the case. As Table 4.4 showed, a uniform change in social rents actually has a slightly smaller impact on RRs and PTRs in London than in the rest of England. But an increase in social rents to 80% of market rents would increase the mean RR and PTR for social tenants in London by more than in the rest of England (0.9ppts compared with 0.7ppts for RRs; 2.4ppts compared with 1.8ppts for PTRs). Results for all other English regions are shown in Appendix Table A.5.

The variation in work incentive effects by family type is less different from that seen in Table 4.4.

To recap the main results from this chapter so far:

- Reducing social rents in England by 1% a year (in nominal terms) for four years from 2016–17 will reduce social rents by 12% relative to previous plans by 2019–20, which equates to an average of £600 per property per year. This will reduce rental income for social landlords by a total of £2.3 billion a year, with £1.3 billion coming from housing associations and £1.0 billion from local authorities.

- This policy largely represents a transfer from social landlords to the exchequer, rather than to social tenants. The £2.3 billion reduction in rents

Table 4.5. The effect of increasing social rents to 80% of market rents on the work incentives of social tenants

	Individuals (millions)	Mean RR			Mean PTR			Workers (millions)	Mean EMTR among workers			% of workers on HB		
		Before	After	Change	Before	After	Change		Before	After	Change	Before	After	Change
England	3.9	75.9	76.6	+0.7	53.8	55.7	+1.9	1.8	50.5	52.8	+2.2	35.7	43.7	+8.0
London	0.8	77.0	77.9	+0.9	54.1	56.5	+2.4	0.4	51.1	53.4	+2.3	42.3	51.2	+8.8
Inner London	0.5	76.2	77.1	+0.9	54.1	56.2	+2.2	0.2	50.7	52.9	+2.2	43.6	50.8	+7.2
Outer London	0.3	78.1	79.1	+1.0	54.2	56.9	+2.6	0.2	51.7	54.1	+2.5	40.4	51.8	+11.4
Rest of England	3.1	75.6	76.2	+0.6	53.7	55.5	+1.8	1.4	50.4	52.6	+2.2	33.9	41.6	+7.7
Single without children	1.4	71.1	72.1	+1.0	55.3	57.6	+2.3	0.6	41.8	43.6	+1.9	27.5	36.7	+9.3
Couple without children, partner not in work	0.3	79.4	80.5	+1.1	65.6	68.0	+2.4	0.1	52.6	55.1	+2.4	32.2	39.1	+6.9
Couple without children, partner in work	0.4	64.3	64.3	–0.0	25.3	27.7	+2.4	0.3	34.2	35.5	+1.3	2.3	4.7	+2.4
Lone parent	0.6	80.1	80.4	+0.3	48.7	49.1	+0.4	0.2	78.6	80.6	+1.9	75.6	84.2	+8.6
Couple with children, partner not in work	0.6	85.6	85.2	–0.4	73.8	72.5	–1.3	0.3	67.2	69.0	+1.7	75.1	82.4	+7.3
Couple with children, partner in work	0.6	78.2	79.6	+1.5	46.6	51.8	+5.2	0.4	44.9	49.0	+4.1	19.2	30.0	+10.7

Note: Sample is individuals aged 22–59. Calculations based on the system of taxes, benefits and social rents described on page 40, and estimates of market rents based on Wilcox (2008). Incomes include imputed value of direct rent subsidy.

Source: Authors' calculations using Wilcox (2008) and TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

breaks down into reduced HB spending by the exchequer of £1.7 billion and increased net-of-rent incomes for social tenants of £0.7 billion (assuming full take-up of HB). The tenants who gain most from this will tend to be towards the middle of the income distribution: better-off households are less likely to be in social housing, while the poorest will typically be receiving HB and see it fall one-for-one as their rent is reduced.

- Reducing social rents strengthens the work incentives of social tenants on average. For example, the 12% reduction in social rents (relative to previous plans) announced in the July 2015 Budget will reduce average RRs among social tenants by 0.3ppts, average PTRs by 0.9ppts and average EMTRs among those in work by 0.9ppts.

- However, the effect of social rent levels on work incentives varies significantly by family type. Single individuals without children, those in couples with a non-working partner and no children, and those with a working partner and children see the biggest average effect on their incentive to be in work. This reflects the fact that these are individuals for whom a decision to work is relatively likely to increase household income above the point where they are entitled to any HB. Hence their net-of-rent income when in work depends on how high their rent is (because it is not covered by HB), but their net-of-rent income when out of work does not (because rent is then covered by HB).

- If social rents were allowed to rise to 80% of market rents, the effects would differ significantly across households, notably in different regions. Social rents would increase by an average of 41% in London but only 14% in the North East. The quarter of a million households in London that would see their incomes fall would lose an average of £1,600 a year, compared with just £317 a year for those affected in the North East. The weakening of social tenants' work incentives would be correspondingly greater in London than in England as a whole. For example, average PTRs in London would rise by 2.4ppts, compared with 1.8ppts in the rest of England.

- The benefit cap can reverse the usual effect of social rent changes on work incentives. For individuals in families who are capped (or would be if they were out of work), cutting social rents can increase out-of-work net-of-rent income, because the cap prevents their HB entitlement from covering all of the rent in the first place. If their earnings (or potential earnings) are sufficiently low that they are entitled to HB when in work, then their in-work net-of-rent income is unaffected by the rent change (because HB entitlement adjusts), and hence their incentive to work is weakened. As a result, the 12% rent cut actually weakens the incentive to work, on average, for those in couples with children and a non-working partner, increasing mean RRs by 0.1ppts and mean PTRs by 0.4ppts.

'Pay to Stay'

Under the coalition government, social landlords were given the discretion to charge market rents to high-income social tenants (defined as families with a combined annual taxable income of over £60,000), a policy known as 'Pay to Stay'. In the July 2015 Budget, the government announced a major extension of this policy, to come into effect from 2017–18. First, the income threshold will be lowered to £40,000 in London and £30,000 in the rest of England. Second, it will become compulsory for social landlords to charge market or 'near market' rents to tenants with income above the relevant threshold. Unlike with the current Pay to Stay policy, the additional income collected by local authorities will have to be returned to HM Treasury (though housing associations will be able to retain the extra income).

At the time of writing, full details of the extended Pay to Stay policy have not yet been announced and the government is consulting on it. The consultation document invites views on how rents should increase as incomes rise beyond the relevant threshold, and on what factors will determine the administrative costs for social landlords associated with the policy.[53] We focus on the first of these issues. In particular, we compare the most extreme option of introducing a 'cliff edge' (where rents jump up to market levels as soon as income exceeds the threshold) with two illustrative options for withdrawing the direct rent subsidy (i.e. increasing rents to market levels) gradually as income rises (which, for good reasons, is the way that most benefits and tax credits are means-tested). In particular, we look at a variant where the government chooses to increase rents by 50p for every pound of income over the threshold until they reach market rents (a 50% 'taper') and a variant where the government chooses to increase rents by 20p for every pound of income over the threshold (a 20% taper).[54]

Figure 4.3 shows how the direct rent subsidy for an example household would fall as its taxable income increased under each of these three options. In each case, the figures are for a social renting household outside London receiving a direct rent subsidy of £3,000 per year (this is our estimate, using Wilcox (2008), of the average direct rent subsidy for those whose rent will rise as a result of Pay to Stay).

Assuming that the definition of income used to calculate rent remains the same as for the current Pay to Stay policy (i.e. a family's combined taxable income), we estimate that about 7% of social renting households (250,000 households) in England will see their rents increase as a result of Pay to Stay. By design, these are the highest-income social tenants, and around 80% are in the top half of the overall income distribution – the policy results in direct rent subsidies being

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[53] Department for Communities and Local Government, 2015a.

[54] Throughout, we assume that Pay to Stay were implemented in 2015–16, and compare this with a situation with no Pay to Stay. We model social rent levels as being 12% below their 2015 levels, which is the size of the cut announced in the July 2015 Budget.

Figure 4.3. Illustrative direct rent subsidy by taxable income for a social renting household outside of London under possible variants of Pay to Stay
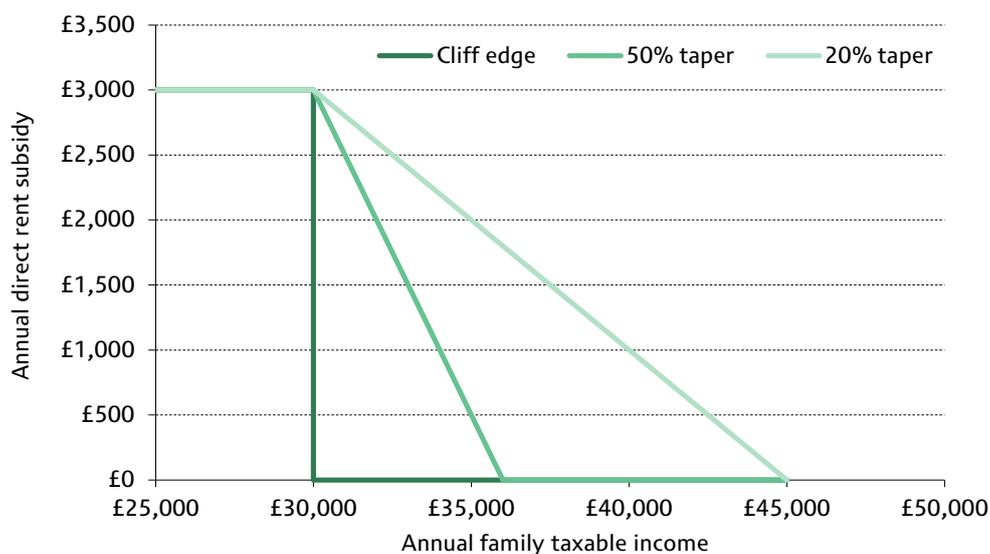
Note: Example shown is a household whose social rent is £3,000 below market levels.

targeted more closely on those with the lowest resources, as per the major stated rationale.[55]

However, the size of the impact on this group will be significantly different depending on how the government chooses to withdraw the rent subsidy. If rents jump up to their market levels (as estimated using Wilcox (2008)) as soon as incomes reach the Pay to Stay threshold (the cliff-edge option), we estimate the total increase in rent paid would be £800 million (a hefty average increase of £3,000 a year per affected household). The impact on tenants' net-of-rent incomes is similar, as very few of those affected are entitled to HB (even after the substantial increase in rent implied by Pay to Stay) given their relatively high incomes. Of that £800 million increase in rents, we estimate that £250 million would go to local authorities and hence be returned to the exchequer (a similar figure to that suggested by the government[56]), and the remainder would go to housing associations.

Instead of a cliff edge, the government could choose to increase rents by, say, 50p for every pound of income over the threshold (the 50% taper). Under this scenario, we estimate that rents would rise, and households' net-of-rent incomes fall, by a total of around £600 million (£2,400 per affected household), raising the exchequer around £200 million. Figure 4.3 illustrates why the change in rents is smaller: some social tenant households with incomes above the threshold see only part of their direct rent subsidy withdrawn. If the government instead chose

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[55] HM Treasury, 2015a, p. 40.

[56] HM Treasury, 2015b.

a 20% taper, the increase in rents (decrease in households' net-of-rent incomes) would fall further to around £450 million a year (£1,700 per affected household), raising the exchequer around £150 million. Increasing rents more gradually has such large effects on revenue and household incomes for two reasons: the incomes of most of those affected are only slightly above the threshold, and the amount of subsidy being withdrawn is large. In combination, these two things mean that with a 20% taper, for example, only 30% of households affected by Pay to Stay would pay the full market rent (with a 50% taper that figure would be 60% and with a cliff edge it would of course be 100%).

Given these revenue figures, introducing a cliff edge might seem an appealing option for the government. However, as with cliff edges in general, it would create inequities and a potentially damaging set of incentives for those with incomes around the threshold. Taking first the question of fairness, it is difficult to justify otherwise-identical social tenants whose incomes differ by £1 facing a difference in rent of thousands of pounds per year. In terms of incentives, consider an individual with a taxable income of £29,999 (or £39,999 in London). An increase of £1 in earnings could lead to an increase in annual rent of thousands of pounds: they would be substantially worse off as a result of increasing their earnings. Equivalently, consider an individual with a taxable income of £30,000 exactly (or £40,000 in London). By reducing their earnings by £1, they stand to gain thousands of pounds a year through lower rents. Such dramatic effects of a £1 change in earnings are clearly an extreme and exceptional case; but more broadly, any pay rise that meant crossing the Pay to Stay threshold would only be financially worthwhile if it were worth more – after tax – than the tenant's direct rent subsidy (£3,000 in our illustrative example). This is clearly hugely damaging to the work incentives of those social tenants with incomes around the threshold.[57] Note that all of the revenue figures above assume that no one changes their income in response to Pay to Stay. To the extent that people respond by reducing their income, the revenue from Pay to Stay will be lower.

Withdrawing the direct rent subsidy gradually as income rises avoids creating these perverse incentives. It does not completely avoid the weakening of work incentives that is inevitably associated with the withdrawal of a subsidy as income rises – there is an inescapable trade-off between work incentives and targeting support on those with the lowest resources, as discussed in Section 3.1 – but it does avoid the most extreme disincentive effects, and in particular the situation where a rise in earnings can make someone worse off. There is no easy answer to the question of precisely what the taper rate should be. As discussed above, for a given threshold, a lower taper rate leads to a smaller increase in rents (fall in net-of-rent incomes), and hence reduces the increase in government

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[57] EMTRs, our standard measure of incentives to earn more, do not capture this effect well. We measure EMTRs by increasing earnings by a penny. The effect of a cliff edge on EMTRs is therefore zero unless the individual concerned is within a penny of the threshold (in which case it would be many thousand percentage points).

revenue. A lower taper rate also reduces the extent to which rent subsidies are targeted on those with lower incomes. And different taper rates have different implications for changes in work incentives. As Figure 4.3 illustrates, the lower the taper rate, the further the taper will extend up the income distribution. Hence, increasing rents quickly as income rises results in a large increase in EMTRs for a small number of people; increasing rents more slowly results in a smaller increase in EMTRs for a larger number of people. For example, introducing a 50% taper would increase the EMTR facing around 150,000 social tenants by 49ppts (to an average of 85%), while introducing a 20% taper would increase the EMTR facing around 300,000 social tenants by 20ppts (to an average of 56%). Averaging these impacts over all working social tenants in England, a 50% taper rate would increase the mean EMTR by 3.6ppts and a 20% taper rate would increase the mean EMTR by 3.1ppts. For context, both of those figures are larger than the impact on mean EMTRs of raising all social rents to 80% of market rents (shown in Table 4.5).

As well as weakening the incentive for some high-income social tenants to increase their earnings, Pay to Stay could also substantially weaken the incentive for some social tenants to be in work at all. If the taxable income of an individual's family is less than the Pay to Stay threshold when that individual is out of work, but above that threshold when they are in work, some of their earnings are effectively lost through higher rent, weakening the incentive to be in work. Under the cliff-edge variant of Pay to Stay, the mean RR and PTR among those individuals in households above the Pay to Stay threshold would increase by 3ppts and 10ppts respectively. Even after averaging the impacts across all social tenants in England, this equates to an increase in the mean RR of 0.6ppts and an increase in the mean PTR of 1.8ppts. These increases are almost as large as those that would result from raising all social rents to 80% of market rents (a policy that affects most social tenants).

If the direct rent subsidy were instead gradually withdrawn using a taper, the impact on incentives to be in work would be smaller, because some social tenants would see a smaller rise in their rents as a result of moving into work. With a 50% taper rate, the mean RR among all social tenants increases by 0.5ppts and the mean PTR by 1.5ppts. With a 20% taper rate, those figures fall to 0.3ppts and 1.0ppts respectively. Here the trade-off facing the government is clear: the larger the increase in social rents (and hence the increase in government revenue), the more Pay to Stay will tend to weaken the incentives of social tenants to be in work.

Table 4.6 collects the key figures describing the impact of Pay to Stay on rents, government revenue and the work incentives of social tenants under each of the three variants examined here.[58]

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[58] All of these figures (and those in the above text) are calculated without universal credit in place. For the equivalent figures with universal credit fully in place, see Appendix C.

Table 4.6. Impacts of possible variants of the Pay to Stay policy

	Aggregate change in rents	Change in exchequer revenue	Change in mean RR	Change in mean PTR	Change in mean EMTR
Cliff edge	+£800m	+£250m	+0.6ppts	+1.8ppts	N/A
50% taper	+£600m	+£200m	+0.5ppts	+1.5ppts	+3.6ppts
20% taper	+£450m	+£150m	+0.3ppts	+1.0ppts	+3.1ppts

Note: Cash figures given in 2015 prices and on an annual basis. Mean work incentive measures for all social tenants aged 22–59. Change in exchequer revenue incorporates the knock-on effects on benefit entitlements. Assumes no behavioural response.
Source: Authors' calculations using Wilcox (2008) and TAXBEN run on uprated Family Resources Survey data, 2010–11 to 2013–14.

A fourth option would be to introduce a taper rate that varies across households. For a given direct rent subsidy, there is a trade-off between tapering it away at a lower rate and preventing the taper from extending a long way up the income distribution. The government could decide that the appropriate balance to strike depends on the amount of direct rent subsidy to be withdrawn. For example, if households receiving particularly large direct rent subsidies were subject to higher taper rates, this could reduce (or eliminate entirely) the extent to which they are subject to the Pay to Stay taper over an especially large range of income.[59]

Yet another option would be to have a series of relatively small cliff edges at different income thresholds, each of which withdraws some fraction of the rent subsidy, rather than a single cliff edge at which all of the direct rent subsidy is withdrawn. This might have practical advantages over a taper – for example, fewer changes in income would need to trigger a reassessment – but at the cost of introducing the problems of cliff edges discussed above (albeit to a lesser extent than if a single, large cliff edge were introduced).

Throughout the above analysis, we have assumed that the measure of income used to determine rent under Pay to Stay is the same as that used for the existing Pay to Stay policy – taxable income, measured at the family level (i.e. the combined taxable income of members of a couple). However, there are other options. One possibility would be to use families' after-tax income instead – more like the income measure used for calculating benefit entitlements.[60] Since £30,000 of taxable income and £30,000 of after-tax income are quite different,

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[59] A particular case of this kind of approach is the withdrawal of child benefit (CB) from higher-income families: 1% (rather than a fixed cash amount) of a family's CB is withdrawn for each £100 of income exceeding £50,000. This means that all families' CB is fully withdrawn once income reaches £60,000, but it also means a more rapid withdrawal of CB for those receiving more CB (i.e. those with more children). However, there are undesirable features of that particular policy that should not be replicated: effective taper rates will increase arbitrarily over time simply due to inflation as nominal CB amounts increase; and the threshold at which the withdrawal begins is fixed in nominal terms over time (rather than uprated in line with prices or earnings).

[60] There are other possibilities too, such as using the individual income of the highest-income family member, which is the basis currently used for withdrawing child benefit.

using after-tax income would mean that the policy affected a different number of people and raised a different amount of revenue. In principle, these differences could be offset by choosing a correspondingly different income threshold, but the government has already specified that the threshold will be £40,000 in London and £30,000 in the rest of England. This highlights the oddity of the government's having specified the level of the income threshold before confirming the definition of income to which it referred. Similarly, increasing rents by (say) 20p or 50p for each pound of after-tax income would have a different effect on EMTRs from increasing them by 20p or 50p for each pound of taxable income, so the government might want to choose a different taper rate depending on its preferred measure of income. If the marginal tax rates of people facing withdrawal of rent subsidies vary (for example, if those just above the Pay to Stay threshold are basic-rate taxpayers but some higher-rate taxpayers are still on the taper), using after-tax income has the advantage that Pay to Stay would add less to the EMTRs of people already facing high tax rates.[61] In practice, the most important factor in the choice of income measure to use might be administrative considerations: some measures of income might be much easier to obtain than others – for example, if data on them are already held by social landlords for other purposes.

In summary, Pay to Stay will reduce the net-of-rent incomes of the highest-income 7% of social tenant households and will weaken the incentives some social tenants face to move into work or increase their earnings. However, the way the policy is designed will be important. The introduction of a cliff edge, at which annual rents increase by thousands of pounds when earnings rise only slightly, would leave some social tenants worse off after a pay rise. It would be better to increase rents gradually, although this would substantially reduce the revenue raised (and the cost to tenants) unless the government decided to raise rents starting from a lower income threshold.

It is worth noting again that, although we have quantified some of the effects of Pay to Stay (in some of its possible forms), it will have other effects too:

- The increase in rental income for housing associations should result in more new investment in social housing (all else equal), so more people may be able to access sub-market rents in future than would otherwise have been the case (though note that this will happen alongside the 1% nominal annual cut in social rents for four years, which is a bigger policy in aggregate and will have the opposite effect).

- Removing such a valuable subsidy from a group of relatively high-income social tenants significantly strengthens their incentive to take up the Right to Buy their home. For example, LA tenants with incomes above the Pay to Stay

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[61] See section 5.3.2 of Mirrlees et al. (2011) for a detailed discussion of assessment based on before- versus after-tax income.

threshold receive a direct rent subsidy of £2,300 per year on average.[62] Removing that subsidy, which might otherwise have applied for the rest of their lives (notwithstanding the current review of lifetime tenancies), could clearly have a large impact on the relative attractiveness of social renting versus owner-occupation (or indeed private renting). In the past, where Right to Buy has been taken up, the size of the social rented sector has fallen, as the properties sold have not been replaced one-for-one.[63]

4.4 Changing social rent levels under universal credit

Universal credit is a new means-tested benefit which is gradually replacing six existing means-tested benefits and tax credits for those of working age: income support, income-based jobseeker's allowance, income-related employment and support allowance, child and working tax credits, and HB. Although the first claims to universal credit were made in April 2013, it has still only been rolled out to a small number of claimants so far (around 100,000 as of August 2015, out of a long-term expected caseload of over 6 million[64]). However, the government's current plans are for all new claims to be for universal credit from the start of 2018, and for most existing claimants to have been moved to universal credit by the start of 2020.[65] Given this long phase-in period, and the transitional protection that applies to existing benefit claimants (meaning that their cash entitlements cannot fall at the point of migration onto universal credit), it will be a long time before the reformed system applies in full to everyone. We simply compare the situation before universal credit is introduced with that when it is fully in place, illustrating the long-run effect of the reform.

The subject of this report is the effects of changing social rents, not the effects of introducing universal credit. We therefore focus here on how the effects of changing social rents will be different under universal credit (owing to different knock-on consequences for benefit entitlements). However, as background to this discussion, and since universal credit is a major reform affecting social tenants, we include an analysis of the impact of universal credit itself on the incomes and work incentives of social tenants in Appendix B.

For present purposes, the key features of universal credit to note are:

- Benefit entitlements for most of the poorest claimants (those with no private income or assets) will be unchanged from the current system.

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[62] The Right to Buy is currently available only to LA tenants. The current plan agreed between the government and the National Housing Federation would see Right to Buy extended to HA tenants on a voluntary basis soon. See of Adam et al. (2015, p. 14) for details.

[63] See Section 2.4 and Chandler and Disney (2015).

[64] 100,000 from DWP Stat-Xplore, retrieved 5 October 2015. Estimate of long-term expected caseload from Office for Budget Responsibility (2014).

[65] Office for Budget Responsibility, 2014.

- As with HB at present, entitlement to universal credit will increase pound-for-pound with social rents (subject to the benefit cap and the 'bedroom tax'). Hence, the effect of changing social rents on tenants' incomes and work incentives will still depend crucially on whether they are (or would be) receiving support for housing costs through the benefit system.

- However, the way that entitlement varies with income, assets and hours of work will be different from under the current system. For many social tenants, entitlement will be withdrawn less sharply as their earnings rise. Consequently, in-work entitlements will typically be higher and entitlement will reach further up the income distribution. This is the main reason the results in this section will differ from those presented above.

- The government argues that the introduction of universal credit is a simplification and so will increase overall take-up rates. If this is borne out, the effects we find by assuming full take-up will be closer to the truth under universal credit than under the current system.

To illustrate how universal credit alters the impacts of social rent changes, we look at how the impact of the 12% reduction in social rents analysed earlier is different with universal credit in place. The effect of universal credit is to slightly reduce the share of the £2.3 billion reduction in social rents resulting from this change that feeds through into higher net-of-rent incomes for social tenants (rather than lower benefit expenditure for the government). This is because a higher proportion of social tenant families will be entitled to universal credit than are currently entitled to HB, and so more households will see a fall in their rent completely offset by a fall in their benefit entitlements. With universal credit fully in place, 1.5 million households gain an average of £400 a year, compared with 1.6 million households gaining an average of £420 without universal credit. The distributional impact of the 12% cut in rents is similar before and after the introduction of universal credit, with slightly smaller gains for the bottom four decile groups once universal credit is in place.

Table 4.7 shows the estimated impact on work incentives of a 12% reduction in social rents before and after the introduction of universal credit. (The numbers for the scenario without universal credit simply repeat numbers from Table 4.4.) It shows that the introduction of universal credit will tend to make average work incentives slightly less sensitive to social rents. Taking first the incentive to be in work at all, with universal credit in place the 12% cut in social rents reduces mean RRs in England by 0.2ppts (compared with a 0.3ppt fall before universal credit is introduced) and reduces mean PTRs by 0.7ppts (compared with a 0.9ppt fall before universal credit is introduced). This reduction in impact is true inside and outside of London and across most family types.

Universal credit dampens the effect of changing social rents on the incentive to be in work because universal credit extends further up the earnings distribution than HB. Most social tenants' out-of-work income is still unaffected by a rent increase (because their benefit rises one-for-one to cover it); but under universal

Table 4.7. The effect of reducing social rents by 12% on the work incentives of social tenants, before and after the introduction of universal credit (UC)

	Individuals (millions)	Change in mean RR		Change in mean PTR		Workers (millions)	Change in mean EMTR among workers	
		Before UC introduced	After UC introduced	Before UC introduced	After UC introduced		Before UC introduced	After UC introduced
England	3.9	−0.3	−0.2	−0.9	−0.7	1.8	−0.9	−0.7
London	0.8	−0.2	−0.2	−0.7	−0.6	0.4	−1.1	−0.6
Inner London	0.5	−0.2	−0.2	−0.6	−0.6	0.2	−1.1	−0.6
Outer London	0.3	−0.3	−0.2	−0.7	−0.5	0.2	−1.0	−0.5
Rest of England	3.1	−0.3	−0.2	−1.0	−0.7	1.4	−0.9	−0.8
Single without children	1.4	−0.5	−0.3	−1.1	−0.9	0.6	−0.8	−0.7
Couple without children, partner not in work	0.3	−0.5	−0.2	−1.2	−0.8	0.1	−0.8	−2.0
Couple without children, partner in work	0.4	+0.0	−0.1	−1.0	−1.2	0.3	−0.7	−0.3
Lone parent	0.6	−0.1	+0.0	−0.2	−0.1	0.2	−0.9	−0.4
Couple with children, partner not in work	0.6	+0.1	+0.1	+0.4	+0.2	0.3	−0.9	−0.2
Couple with children, partner in work	0.6	−0.6	−0.4	−2.3	−1.5	0.4	−1.6	−1.4

Note: Sample is individuals aged 22–59. Calculations based on the system of taxes, benefits and social rents described on page 40. Incomes include imputed value of direct rent subsidy.

Source: Authors' calculations using TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

credit, more people are entitled to means-tested housing support when in work – 51% of working social tenants, compared with 36% entitled to HB under the current benefit system. As a result, fewer social tenants see their in-work income, and therefore their incentive to be in work, reduced by a rent increase.

Universal credit also reduces the impact of social rent changes on average EMTRs. With universal credit in place, the 12% cut to social rents reduces the mean EMTR by 0.7ppts, compared with a reduction of 0.9ppts under the current system. This is because under universal credit, benefit entitlement among social tenants stretches further up the earnings distribution, to where there are fewer social tenants, so reducing rents, and therefore the point at which benefit entitlement is exhausted, by a given amount takes fewer people out of the scope of means-testing and the associated high EMTRs. Before the introduction of universal credit, a 12% cut in social rents reduces the proportion of working social tenants receiving some HB by 3.6ppts. But the same cut only reduces the proportion of working social tenants receiving some universal credit by 1.5ppts.

Universal credit also changes the impact of the other social rent changes we consider: an increase to 80% of market rents and Pay to Stay. Again it slightly dampens the effect of changes on incomes and work incentives because more of those affected are entitled to universal credit than are currently entitled to HB. For more details on universal credit and Pay to Stay, see Appendix C.

5. Conclusion

This report has analysed the choice over the level of rent charged to tenants in social housing. It has set out the consequences of different choices and has quantified the impacts on tenants' work incentives and their net-of-rent incomes. We have focused particularly on the effects of specific reforms made to social rent policy in the recent past or planned for the near future, and we have shown how the impacts of changing social rents are affected by recent or imminent welfare reforms.

As outlined at the start, one extremely important fact has formed the backdrop to this report: the cost of housing has risen rapidly, in no small part because of constrained housing supply. Finding a solution to that problem is one of the most important challenges facing public policy today. In the meantime, while the problem continues there are no easy answers for welfare policy. Either we spend increasingly large amounts subsidising housing costs (at the expense of other uses of public money and with potentially damaging effects on incentives) or we risk the cost of housing pushing increasing numbers of people into hardship. Understanding these trade-offs, and forming a coherent view of how to balance them, is only becoming more important. This report feeds into that: sub-market rents in the social rented sector are one of the main ways in which we subsidise the cost of housing and are, to some extent, an alternative to the increasingly-expensive housing benefit.

How clear, then, is the overall tenor of social rent policy at present? For better or worse, the government seems to believe that continued access to subsidised social housing should be based more on tenants' current circumstances. This belief looks implicit in the introduction and planned extension of 'Pay to Stay' and also in the introduction of fixed-term tenancies and review of the use of lifetime tenancies. These policies mean that direct rent subsidies could be withdrawn from tenants whose current resources are deemed high enough (by raising the rent in their existing property or, if social landlords choose, by not renewing their tenancy).

These reforms make, or could make, the rent subsidies provided through sub-market rents slightly more similar to those provided through housing benefit. Pay to Stay means that social tenants will find that their entitlement to a direct rent subsidy can be regularly reassessed to account for changes in their circumstances. Fixed-term tenancies may, depending on how social landlords use them, mean that entitlement to social housing – including the direct rent subsidy that it typically entails – can be withdrawn if tenants are no longer deemed in sufficient need. As such, the trade-offs associated with moving in this direction essentially mirror the trade-offs associated with housing benefit. Frequent reassessment does indeed ensure that entitlement is targeted more closely on those with low resources. However, it also creates an incentive for current subsidy recipients to act in ways that increase their chances of continuing to receive the direct rent subsidy (for example, to keep their earnings lower than

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they would otherwise have done). In the case of Pay to Stay, we have shown that the vast majority of those whose rents increase will be in the top half of the income distribution, but that financial work incentives would be weakened significantly on average – with the details depending on how exactly it is implemented.

In another respect, a coherent sense of direction in social rent policy seems to be lacking. On the one hand, a new 'Affordable Rent' model has been introduced that (despite the name) allows for substantially higher rents in some social housing than would otherwise have been the case. A stated aim of this policy was to allow social landlords to finance greater housing construction (in the face of cuts to capital grants, which act to reduce construction). On the other hand, the July 2015 Budget announced that, over the next four years, social rents will be reduced substantially (by 4% in nominal terms, and an expected 8% in real terms and 12% relative to previous plans). This move is expected to reduce social housing construction. We have shown that these policies – one to allow rent increases and one to reduce rents – have sharply contrasting effects on the work incentives and net-of-rent incomes of social tenants. In addition, the July 2015 Budget announcement came after just one year of CPI + 1% rent increases, despite the coalition government saying that this policy would apply for 10 years with the aim of providing certainty.

All in all, it is difficult to discern a coherent view within government about how to balance the trade-offs associated with setting social rent levels. We hope that the analysis and quantification of these trade-offs in this report will help to inform thinking around social rent policy in future.

Appendix A: Supplementary Results

Table A.1. Impact of sub-market rents on financial work incentives for social renters in England with and without the benefit cap

	Impact of sub-market rents, given HB (ppts)	
	With benefit cap	**Without benefit cap**
Mean RR	−1.0	−1.5
Mean PTR	−3.1	−4.3
Mean EMTR	−4.6	−4.7

Note: Individuals aged 22–59. Calculations based on the system of taxes, benefits and social rents described on page 40, and estimates of market rents based on Wilcox (2008). Incomes include imputed value of direct rent subsidy.
Source: Authors' calculations using Wilcox (2008) and TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

Table A.2. The effect of a 12% reduction in social rents on the rents and incomes of social tenants by region

	Total fall in rents (per year)	Mean fall in rent (per year)	Number of households that gain (thousands)	Average gain among gainers (per year)	Average gain among gainers (% of income)
North East	£158m	£505	135	£302	1.4%
North West	£223m	£496	204	£329	1.5%
Yorkshire and Humber	£298m	£539	239	£353	1.6%
East Midlands	£157m	£513	126	£327	1.5%
West Midlands	£237m	£558	164	£352	1.6%
East	£100m	£566	74	£425	1.6%
London	£535m	£767	257	£583	1.9%
South East	£436m	£666	264	£517	1.8%
South West	£175m	£592	118	£453	1.7%
England	£2,318m	£599	1,581	£419	1.7%

Note: Calculations based on the system of taxes, benefits and social rents described on page 40. Incomes include imputed value of direct rent subsidy.
Source: Authors' calculations using TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

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Table A.3. The effect of reducing social rents by 12% on the work incentives of social tenants by region

	Mean RR			Mean PTR			Mean EMTR among workers			% of workers on HB		
	Before	After	Change	Before	After	Change	Before	After	Change	Before	After	Change
England	76.2	75.9	–0.3	54.7	53.8	–0.9	51.5	50.5	–0.9	39.3	35.7	–3.6
North East	76.0	75.6	–0.3	55.1	54.1	–1.0	48.8	48.3	–0.5	35.0	31.5	–3.6
North West	75.1	74.7	–0.4	54.9	53.9	–1.0	50.5	48.9	–1.6	37.2	31.5	–5.6
Yorkshire and Humber	74.6	74.3	–0.3	54.0	53.0	–1.0	52.1	51.6	–0.5	35.0	32.7	–2.3
East Midlands	74.0	73.6	–0.3	54.3	53.3	–1.0	52.4	51.3	–1.1	37.9	33.3	–4.5
West Midlands	76.5	76.1	–0.4	56.4	55.3	–1.1	53.2	52.0	–1.2	41.0	37.6	–3.4
East	76.4	76.1	–0.3	53.1	52.3	–0.9	46.1	45.7	–0.5	29.9	28.6	–1.4
London	77.2	77.0	–0.2	54.8	54.1	–0.7	52.2	51.1	–1.1	46.3	42.3	–3.9
South East	76.9	76.6	–0.3	54.7	53.7	–1.0	52.6	51.6	–1.0	39.2	35.6	–3.6
South West	78.4	78.2	–0.3	54.1	53.1	–1.0	50.1	49.4	–0.7	39.1	36.1	–3.1

Note: Sample is individuals aged 22–59. Calculations based on the system of taxes, benefits and social rents described on page 40. Incomes include imputed value of direct rent subsidy.

Source: Authors' calculations using TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

Table A.4.The effect of an increase in social rents to 80% of market rents on the rents and incomes of social tenants by region

	Total increase in rents (per year)	Mean increase in rent (per year)	Number of households that lose (thousands)	Average loss among losers (per year)	Average loss among losers (% of income)
North East	£159m	£506	132	–£317	–1.5%
North West	£234m	£521	199	–£363	–1.7%
Yorkshire and Humber	£337m	£610	235	–£416	–1.9%
East Midlands	£244m	£797	125	–£521	–2.4%
West Midlands	£351m	£828	161	–£560	–2.6%
East	£259m	£1,471	76	–£1,055	–4.1%
London	£1,617m	£2,318	254	–£1,600	–5.3%
South East	£1,311m	£2,004	264	–£1,504	–5.4%
South West	£463m	£1,571	116	–£1,158	–4.6%
England	£4,974m	£1,286	1,564	–£887	–3.6%

Note: Calculations based on the system of taxes, benefits and social rents described on page 40, and estimates of market rents based on Wilcox (2008). Incomes include the imputed value of direct rent subsidy.
Source: Authors' calculations using Wilcox (2008) and TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

Table A.5. The effect of increasing social rents to 80% of market rents on the work incentives of social tenants by region

	Mean RR			Mean PTR			Mean EMTR among workers			% of workers on HB		
	Before	After	Change	Before	After	Change	Before	After	Change	Before	After	Change
England	75.9	76.6	+0.7	53.8	55.7	+1.9	50.5	52.8	+2.2	35.7	43.7	+8.0
North East	75.6	76.0	+0.4	54.1	55.2	+1.1	48.3	48.9	+0.6	31.5	35.5	+4.1
North West	74.7	75.1	+0.4	53.9	55.1	+1.2	48.9	50.7	+1.8	31.5	37.9	+6.4
Yorkshire and Humber	74.3	74.7	+0.4	53.0	54.3	+1.2	51.6	52.6	+1.0	32.7	37.0	+4.3
East Midlands	73.6	74.2	+0.5	53.3	54.8	+1.5	51.3	53.0	+1.6	33.3	39.5	+6.1
West Midlands	76.1	76.7	+0.6	55.3	56.9	+1.6	52.0	53.8	+1.9	37.6	44.2	+6.6
East	76.1	76.8	+0.7	52.3	54.9	+2.6	45.7	49.4	+3.7	28.6	39.1	+10.5
London	77.0	77.9	+0.9	54.1	56.5	+2.4	51.1	53.4	+2.3	42.3	51.2	+8.8
South East	76.6	77.4	+0.8	53.7	56.4	+2.6	51.6	55.1	+3.5	35.6	47.4	+11.8
South West	78.2	78.9	+0.8	53.1	55.7	+2.6	49.4	52.6	+3.2	36.1	45.4	+9.4

Note: Sample is individuals aged 22–59. Calculations based on the system of taxes, benefits and social rents described on page 40, and estimates of market rents based on Wilcox (2008). Incomes include imputed value of direct rent subsidy.

Source: Authors' calculations using Wilcox (2008) and TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

Appendix B: The Effect of Universal Credit on the Incomes and Work Incentives of Social Tenants

Universal credit is a new means-tested benefit which is gradually replacing six existing means-tested benefits and tax credits for those of working age: income support, income-based jobseeker's allowance, income-related employment and support allowance, child and working tax credits, and housing benefit (HB). Its basic structure is as follows:[66]

- For each family, there is a maximum entitlement (consisting of a basic element plus additional elements for children, disability, rents and so on), which is payable to those with no private resources. For most families, maximum entitlement under universal credit is the same as under the current system: the different elements mirror those in the existing system (the child element mirroring child tax credit, the rent element mirroring HB, and so on – though this is not quite true for disability elements). This means that support for the poorest will typically be unchanged from the current system. It also means that entitlement to universal credit, like HB, will normally increase or decrease pound-for-pound with social rents (exceptions are those affected by the benefit cap and the 'bedroom tax' – see Section 2.6).

- Entitlement is reduced by 65p for each pound of after-tax earnings until it is exhausted (though families with children or with a disabled member can earn a certain amount – £192 per month for tenants or £397 per month for non-tenants from April 2016 – before their universal credit starts to be withdrawn). This is much simpler than the way that work affects entitlements under the current system, which has separate (but often overlapping) means tests for different benefits and tax credits, and hours-of-work thresholds at which various entitlements rise or fall. As a result, there are many winners and losers among working families, depending on combinations of earnings, hours of work and family circumstances. Overall, in-work entitlement for social tenants tends to be higher under universal credit and to extend further up the income distribution (though the reverse is true for owner-occupiers).

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[66] For a more detailed description of how universal credit entitlement is calculated, see Hood and Oakley (2014). Other aspects of universal credit, such as the assessment and payment processes and work-search requirements, also represent important changes from the existing system, but we do not discuss them here. As in Chapter 4, we analyse universal credit as if it were fully in place, ignoring the gradual roll-out and the transitional protection that means existing benefit and tax credit claimants will not see their cash entitlements reduced at the point they are transferred to universal credit.

- Unearned income and savings reduce universal credit entitlement much like they currently reduce benefit entitlements – but more sharply than they currently reduce tax credit entitlements.

On average, the introduction of universal credit has almost no effect on the incomes of social tenants (increasing them by 0.1%). However, that masks variation in the impact of universal credit across households, including systematic variation by income and by family type. The principal gainers are low-income working households; the principal losers are non-working households with significant amounts of unearned income or assets (who are therefore further up the income distribution). But even among family types such as these, there is significant variation in the impacts of universal credit.

Universal credit also has important impacts on the financial work incentives facing social tenants. Again, these effects vary by family type. Those without a working partner (including single adults) have their incentive to be in work strengthened on average, as in-work entitlements tend to be higher under universal credit while out-of-work entitlements are typically unchanged. But the opposite applies to those with a working partner. With one member of the couple in work, families are more likely to be entitled to support (and any entitlement is likely to be higher) under universal credit than under the previous system; so under universal credit the family has more to lose by the second partner working as well. Across the whole population of social tenants, the mean RR falls by 1.7ppts and the mean PTR by 4.8ppts: the strengthening of incentives among those without working partners outweighs the weakening among those with working partners. And incentives to be in work are strengthened most where they are currently weakest. Under the current system, over a quarter of social tenants face a PTR of above 70%, with around one in ten having a PTR of over 80%. With universal credit in place, only around one in ten social renters has a PTR of over 70% and almost none has a PTR of over 80%.

In contrast to its effect on the incentive to be in work at all, universal credit does not, on average, strengthen the incentive that working social tenants have to increase their earnings slightly: the mean EMTR for social renters actually increases by 0.5ppts.

- At present, many working social tenants are receiving both tax credits and HB, and face having both of those reduced if they increase their earnings (as well as paying more income tax and National Insurance contributions and potentially having their council tax support reduced too), giving them extremely high EMTRs. Under universal credit, this will no longer apply: the single taper rate (65p per pound of after-tax earnings) is the same as that for HB, but much lower than that for HB and tax credits combined. Thus some of the weakest incentives for people to increase their earnings will be mitigated.

- On the other hand, many social tenants whose family income is too high for them to be entitled to any means-tested benefits and tax credits at the

moment will be entitled to universal credit when it is introduced, and will therefore face losing it if they increase their earnings.

Across the population of social tenants as a whole, the latter effect is larger and so the average EMTR rises. But the picture differs widely by family type: lone parents are much more likely to be in the first position (facing withdrawal of both tax credits and HB at present), and they see a large fall in their average EMTR, while people in couples with children are more likely to become newly eligible for universal credit, and they see their average EMTR increase.

One advantage of this reform is that it is the very highest – and most damaging – EMTRs that are reduced by universal credit, and somewhat less high EMTRs that are increased. Figure B.1 shows the distribution of EMTRs among working social tenants before and after the introduction of universal credit. It shows that, for example, before the reform a large fraction of working social tenants share the same EMTR of 40.2% (the effect of basic-rate income tax and standard National Insurance contributions);[67] some 20% of working social tenants have an EMTR below that level; and 35% – mostly those facing withdrawal of means-tested benefits or tax credits – have an EMTR above that. By spreading means-testing further up the income distribution, universal credit increases the proportion with an EMTR above 40.2% from 35% to 43%. But under the current system, almost 30% of working social tenants have an EMTR of over 80% and almost 20% have an EMTR of over 90%; with universal credit fully in place, less than 10% have an EMTR of over 80% and none has an EMTR of over 90%.

Figure B.1. The impact of universal credit on the cumulative distribution of effective marginal tax rates for social renters
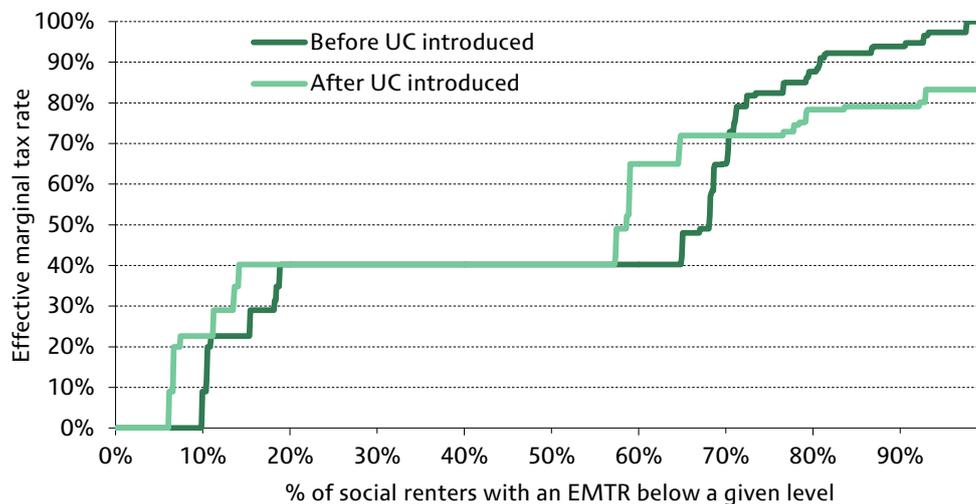
Note: Sample is individuals aged 22–59. Calculations based on the expected April 2019 tax and benefit system.
Source: Authors' calculations using TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

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[67] Recall that we include employer as well as employee National Insurance contributions in our calculations.

Appendix C: Universal Credit and Pay to Stay

The introduction of universal credit will change the effect on incomes and work incentives of reforms to social rents, because the knock-on consequences for benefit entitlements will be different. In this appendix, we briefly discuss how the effect of Pay to Stay will differ once universal credit is fully in place.

Table C.1 provides the key figures describing the impact of Pay to Stay on rents, central government revenue (net of changes in benefit entitlements) and work incentives with universal credit fully in place (under each of the three illustrative variants of Pay to Stay discussed in Section 4.3). A comparison with Table 4.6 reveals that universal credit slightly dampens the effect of Pay to Stay on the incomes and work incentives of social tenants. This is because, as discussed in Section 4.4, entitlement to support for rents will reach further up the income distribution under universal credit than it does under the current system. As a result, more of those affected by Pay to Stay will be entitled to universal credit than are currently entitled to housing benefit. This slightly reduces the effect of Pay to Stay on incomes, as more of those affected will see an increase in benefit entitlement cover some or all of the rent rise. It also slightly dampens the effect of Pay to Stay on the incentive to be in work, on average. Pay to Stay weakens work incentives because it means that some people see rent rise when their earnings increase. Under universal credit, more people in that situation would find that their benefits rise to cover the rent increase.

Table C.1. Impacts of possible variants of the Pay to Stay policy with universal credit fully in place

	Aggregate change in rents	Change in exchequer revenue	Change in mean RR	Change in mean PTR	Change in mean EMTR
Cliff edge	+£800m	+£200m	+0.5ppts	+1.7ppts	N/A
50% taper	+£600m	+£200m	+0.5ppts	+1.4ppts	+3.3ppts
20% taper	+£450m	+£150m	+0.3ppts	+1.0ppts	+2.8ppts

Note: Cash figures given in 2015 prices and on an annual basis. Mean work incentive measures for all social renters aged 22–59. Change in exchequer revenue incorporates the knock-on effects on benefit entitlements. Assumes no behavioural response.
Source: Authors' calculations using Wilcox (2008) and TAXBEN run on uprated data from the Family Resources Survey, 2010–11 to 2013–14.

Universal credit will also reduce the impact of the introduction of a Pay to Stay taper (relative to a world without Pay to Stay) on the incentive for social tenants to increase their earnings a little. The EMTR of those receiving support for their housing costs would be unaffected by the introduction of a Pay to Stay taper (as the increase in rent that accompanies an increase in earnings is offset by an increase in benefit entitlement). Since more of those affected by Pay to Stay will receive support for housing costs under universal credit, the impact of mean

EMTRs will be smaller. With universal credit, the impact of a 50% taper would be to increase the EMTRs of those on the taper by an average of 42ppts (to 80%), compared with an increase of 49ppts without universal credit. Similarly, a 20% taper would increase the EMTRs of those on the taper by an average of 18ppts (to 56%), compared with an increase of 20ppts without universal credit.

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