The chancellor's boost to Local Housing Allowance offers only a temporary reprieve on rent affordability

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Summary

- At the Autumn Statement the chancellor announced that Local Housing Allowance (LHA) rates would be increased to the 30th percentile of local rents from April next year. This follows a four-year freeze that has caused housing affordability to fall sharply in the face of surging rents. But since LHA rates will be frozen at their new level, this is only a temporary solution.

- General inflation may have peaked, but Generation Rent's forecast suggests that we are just over halfway through the post-pandemic surge in rents. We estimate that average rents will rise by around 8.5% in England between now and late 2025. By then they will be 14.2% higher than the reference rents used to determine the April 2024 LHA rates.

- For households relying on benefits this will return housing affordability to its current unsustainable levels just 18 months after the LHA increase takes effect. A family renting a typical two-bedroom house will have to find around £1,370 each year more from other sources to cover rising rent.

- It is past time for the government permanently to re-establish the link between LHA rates and the 30th percentile of local rents so that support automatically changes with housing costs each year.

Generation Rent

Surging rents and declining affordability since 2020

For most of this year all eyes have been on the Renters (Reform) Bill, which has the potential to radically improve conditions for renters if we get it right. But while security for renters may be moving in the right direction, affordability of private sector rents has been deteriorating at an alarming rate.

Rents have been rising fast across the UK since the summer of 2021, with rent on [new lets] surging by around 10% last year. This is gradually feeding through to the whole private rented sector as people move house and some landlords increase rents for sitting tenants, with [average rents] across the UK up by 8.1% in the past 12 months according to the new ONS Price Index for Private Rents (PIPR). For those of us in the private rented sector who rely on Housing Benefit or Universal Credit, putting a roof over our family's head is becoming increasingly unaffordable.

Despite the alarmingly sharp growth in rents, LHA rates, used to calculate people's maximum Housing Benefit or Universal Credit entitlement, have been frozen since April 2020. Back then, rates were aligned with the 30th percentile of rents observed in each local area over the 12 months to September 2019. Today average rents in England are 18.3% higher than they were then, and for people renting a new property the increase has been substantially more than that.

We can get a sense of what recent rent inflation means for household finances for a family living in a place with fairly typical rents like York. In 2018-19 the rent on a 30th percentile two-bed house in York was £150 per week.[1] Today, we estimate the equivalent property costs £183 to rent.[2] That means the family now has to make up a shortfall of over £33 per week, or £1,700 per year, to rent the same house. For some of the poorest families in the country this represents an eyewatering amount of money to have to find.

For that reason the chancellor's decision in the Autumn Statement significantly to increase LHA rates, back to the 30th percentile of local rents in 2022-23 from April next year, is hugely welcome.[3] This will benefit 1.6 million renter households to the tune of almost £800 per year on average. That will cut poverty and stem rising homelessness.

But sadly it's only a temporary reprieve for renters. From April 2024 LHA rates will once again be frozen in cash terms, with no increase planned for April 2025 or subsequently. And while we may be over the worst of the wider surge in inflation, there's a lot more pain to come on private rents which tend to lag the headline inflation rate.[4]

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[1] LHA 2023-24 [tables].

[2] This compares the 30th percentile of rented 2-bed properties in 2018-19 to the 30th percentile cost in 2021-22 grown forward to October 2023 using PIPR for York.

[3] The 30th percentile rent figures used to set April 2024 LHA rates will be based on observed rents in the 12 months up to the end of September 2023.

[4] When referring to 'rents' in this note, we mean average rents as measured by PIPR, the underlying rent data for which also determines LHA levels.

A big rent squeeze is still to come

How bad could things get? To take stock of the outlook for rents we have developed a rental forecast model. Our model is based loosely on the findings of two econometric studies that quantify what drives changes in rents.

A very recent study published by the New Zealand government finds that:

> "[O]ver the past 20 years, nominal wage inflation and the relative supply and demand of dwellings are the two key drivers of rent inflation [...] When the effect of other factors is excluded, a 1 percent increase in nominal wages leads directly to a 1 percent increase in new tenancy rents. A 1 percent increase in people per dwelling leads to a 1.5 percent increase in rents at the national level."

Importantly the authors find only a small and often not statistically significant relationship between rents and mortgage rates. This underlines the fact that, just as landlords didn't cut rents when interest rates fell in the 2010s, they're unlikely to be able to pass on the cost of higher mortgage rates now except to the extent permitted by rising wages. Landlords tend to take both the upside and the downside of changes in interest rates – which is one reason we are seeing steeply rising numbers of landlord in arrears.

Although modelled differently, this study's findings largely accord with the 2016 Oxford Economics study for the Redfern Review into home ownership (led by one of the authors), which concluded that:

> "[A] one percent increase in real earnings per household raises rent by 0.78 percent; and a one percent increase in the number of houses or a one percent fall in the number of households lowers rent by 1.73 percent."

Drawing on the broad scale of these effects we have built a simple model of rent growth. We assume that a 1% increase in average earnings raises average rents by 1.1% after 12 months. This slightly higher sensitivity of rent to incomes compared to the one found in the New Zealand study is chosen to make the prediction model fit the historical data for England more closely. Meanwhile, as in the New Zealand study we assume that a 1% increase in the population per dwelling raises rents by 1.5%.[5] In our model no other factors drive rents – a reasonable simplification in line with the message from the two studies.

This model predicts the past evolution of rents very well. Chart 1 compares the actual ONS rent index since 2010 to the one predicted by the model, illustrating that it does a fairly good job of anticipating changes in actual rents.[6] That suggests it will be a decent guide to what might be coming down the track.

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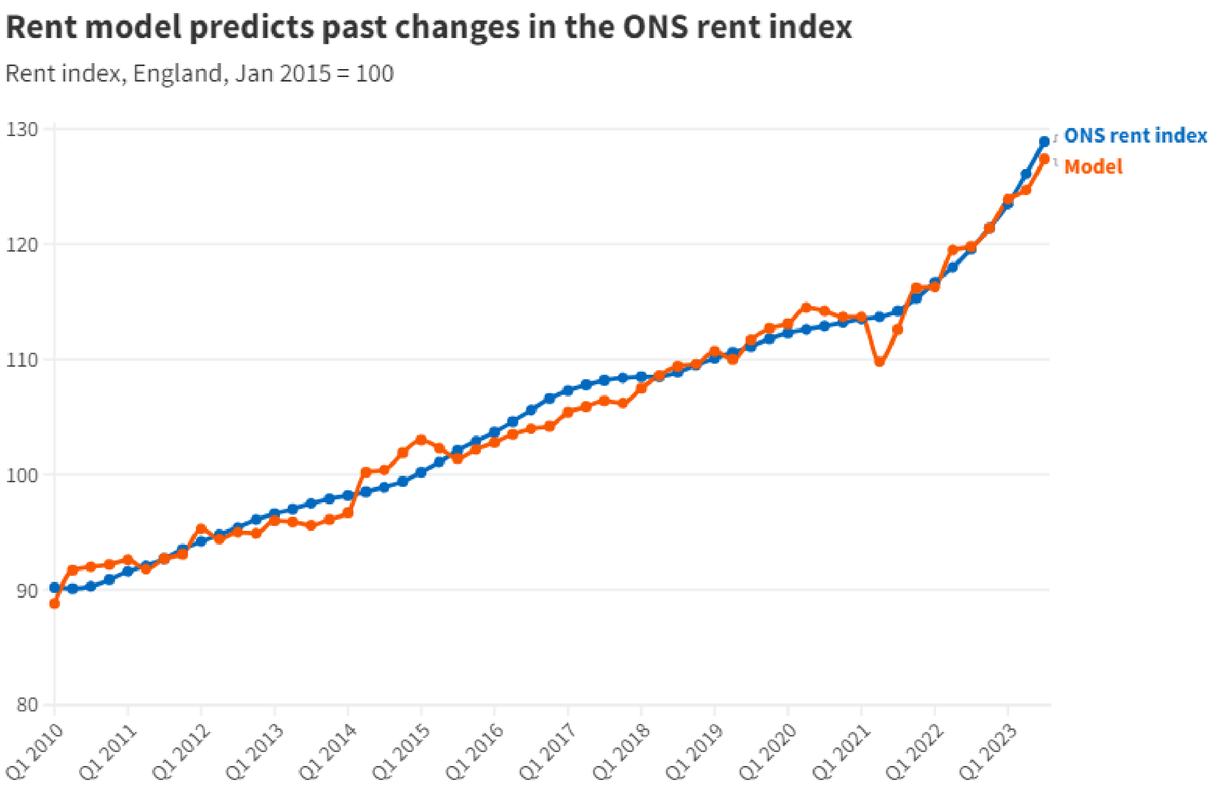
[5] A four-quarter lag in wages changes offers the best fit to changes in the rent index. Since rent rises tend to be smaller and less frequent for sitting tenants a significant lag is unsurprising.

[6] The new ONS PIPR index begins in January 2015. Before that date we use the previous ONS Index of Private Housing Rental Prices (IPHRP).

Chart 1

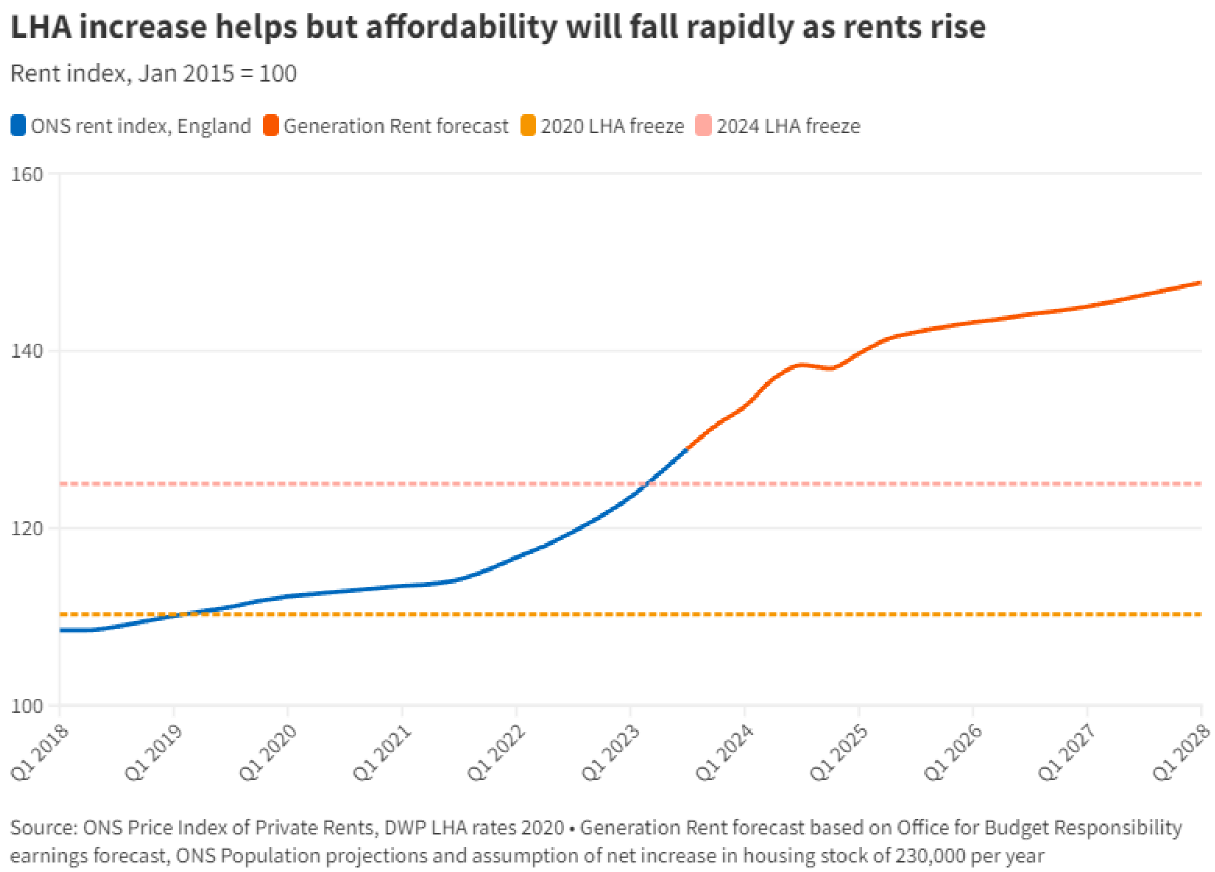


Source: ONS Index of Private Housing Rental Prices, ONS Price Index of Rent Prices, Generation Rent model • Model based on ONS Average Weekly Earnings, Population and Dwelling Stock Estimates

We can use the same model to generate a rent forecast for England based on inputs for wage growth (the OBR's latest forecast for average earnings growth), population (ONS population projections) and an assumption about the rate of growth in housing supply (we assume that net additions continue at the average rate seen in the past five years, equivalent to 230,000 net additions per year).[7]

[7] The model also suggests that ramping up housing supply to hit 300,000 per year would also have a beneficial impact, reducing rents by around 1.5% after four years compared to a rate of 230,000.

Chart 2



This resulting forecast shown in Chart 2 suggests that rents will continue to rise strongly for a while yet. Indeed, right now we are likely just over half of the way through the post-pandemic rent surge. By the last quarter of 2025, rents in England are likely to be around 8.5% higher than they are today and 14.2% higher than the reference rents that will determine April's new LHA rates. For those reliant on benefits, that will return housing affordability most of the way back to its current unsustainable levels just 18 months after the LHA increase takes effect.

On this national projection our typical household in York would have to cover a £25 weekly shortfall between their LHA and their rent, a chasm of over £1,300 per year, by late 2025. This is fairly typical of the national picture, with the shortfall for a two-bedroom house across all rental areas in England set to average £1,370 annually. For some, such as those starting a new tenancy at that point, the shortfall could be significantly higher. And affordability for those on LHA will continue to deteriorate thereafter.

Policymakers need to act to prevent a collapse in affordability

Surging rents are going to create a lot of rough justice among renters. Sitting tenants – who typically, though not always, see smaller rent increases - getting decent pay rises may even see their rent affordability improve. But people who have to move house or who aren't seeing rapid pay growth will be heavily squeezed. Most of all, families who rely on Housing Benefit or Universal Credit will face a massive reduction in housing affordability once again unless a more permanent policy fix is found for uprating LHA.

Fears that a more adequate housing support regime would simply benefit landlords by allowing them to raise rents are unfounded. Past research by the IFS has demonstrated that such an increase would have a negligible impact on rent levels, with almost all of the support benefiting tenants.

As the Renters Reform Bill continues its journey towards the statute book, we have an opportunity to improve security for renters permanently. But when it comes to affordability, the chancellor's welcome decision to increase LHA rates is only a temporary fix given the alarming deterioration of housing affordability that lies ahead.

It is past time for the government not just to raise and freeze housing support every now and again, but permanently to re-establish the link between LHA rates and the 30th percentile of local rents so that support automatically changes with housing costs. Only then will we put a safety net under unaffordable rent.

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