Response of IFS researchers to "Pay to Stay: Fairer Rents in Social Housing"

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This consultation response draws heavily on parts of a recent IFS report, which analysed policy choices around social rents.[1] We focus on question 1 in the consultation document – around the precise relationship between income and rents – rather than question 2, which asks for evidence on the administrative costs of implementation and which we are not best placed to answer.

To illustrate the main trade-offs, we include results from a modelling exercise. Section 4.1 of the aforementioned report contains a detailed description of the underlying methodology. 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 of £40,000 in London or £30,000 elsewhere in England) with two illustrative options for a tapered approach, where the direct rent subsidy is withdrawn (i.e. rents are increased to market levels) gradually as income rises further above the threshold. (For good reasons, this 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).[2]

Figure 1 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 whose rent is £3000 per year below the market level (this is our estimate 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 existing, voluntary 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. By design, these are the

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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

Figure 1. Illustrative direct rent subsidy by taxable income for a social renting household outside of London under possible variants of Pay to Stay
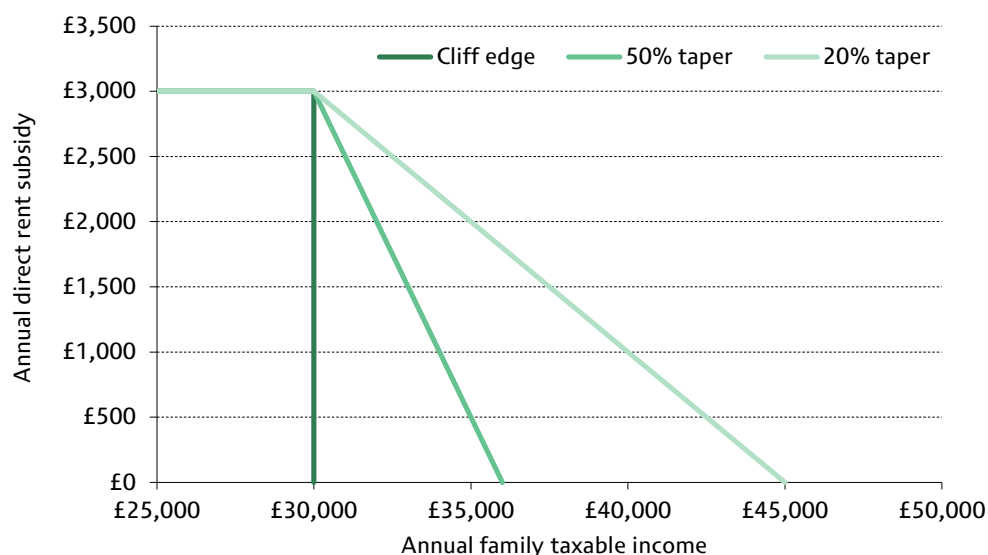
Note: Example shown is a household whose social rent is £3,000 below market levels.

targeted more closely on those with the lowest resources, as per the major stated rationale.[3]

However, the size of the impact on this group will be significantly different depending on how the government chooses to withdraw the rent subsidy. Assuming for the moment no behavioural response to this policy (which is not particularly realistic, and is almost certainly implausible in the case of a cliff-edge – see below), then under the cliff-edge option we estimate the total increase in rent paid across England would be £800 million per year (an average increase of £3,000 per affected household). The impact on tenants' net-of-rent incomes is similar, as very few of those affected are entitled to housing benefit (HB) - even after the substantial increase in rent implied by Pay to Stay - given their relatively high incomes (interactions with the benefit system will however be more important under universal credit – see below). 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

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[3] HM Treasury, *Summer Budget 2015*, p. 40. Note that when assessing where the affected households are in the overall income distribution, we add the value of the direct rent subsidy received by social tenants to their cash income. This is appropriate – it recognises that the subsidised rent enables tenants to spend more on other goods and services than an otherwise-identical person paying market rent, and in particular it treats a direct rent subsidy the same as a cash subsidy provided through housing benefit.

official costing of the policy[4]), 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 (again assuming no behavioural response to the policy) 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 1 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 a 20% taper, then in the absence of behavioural response 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.

The sensitivity of the impacts of Pay to Stay to these choices is quite large 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. However, it would create inequities, and a potentially damaging set of incentives for those with incomes around the threshold - which in turn would probably mean that the revenue raised after behavioural responses is significantly less than the figures above suggest.

Taking first the question of equity, 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. Of course, those are extreme examples. But more broadly, any pay rise which meant crossing the Pay to Stay threshold would only be financially worthwhile if it were worth more – after direct tax – than the tenant's direct rent

subsidy (£3,000 per year, on average). This is clearly hugely damaging to the work incentives of those social tenants with incomes around the threshold. This would be particularly true for those whose rents would otherwise be particularly far below market levels (such as tenants in London and/or in larger properties, whose rents tend to be subsidised more heavily). It would create a range of income above the threshold within which nobody should want to locate (because, after paying rent, they would be better off if their income were lower than that). If some people respond to these large incentives by not locating in that range and instead locating just below the threshold, they will pay no extra rent and the revenue raised will be less than under the assumption of no behavioural response. (In addition, of course, if they earn less in response then this will also reduce direct tax revenues.) This seems a highly likely scenario.

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 - 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, and hence also reduces the increase in central government 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 work incentives. In what follows we refer to three measures of financial work incentives (the first measures the incentive for those already in work to increase their earnings slightly; the next two measure the incentive to be in work at all):

- Effective Marginal Tax Rates (EMTRs): the proportion of a small increase in earnings taken in tax and withdrawn benefits;
- Replacement Rates (RRs): income if out of work as a proportion of income if in work;
- Participation Tax Rates (PTRs): the difference between in-work and out-of-work income, as a proportion of pre-tax earnings (equivalently, the proportion of earnings taken in tax and withdrawn benefits).[5]

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[5]The measure of income is household income. For individuals in couples, we look at their incentive to work assuming that the work behaviour of their partner remains unchanged.

As Figure 1 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, focusing (as we do throughout) on individuals aged 22-59, 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, these impacts are larger than the average effect on social tenants' work incentives of raising all rates of income tax by 5p (which would increase the mean EMTR by 2.8ppts). Note that EMTRs are not useful for describing impacts of a cliff-edge (which effectively creates an infinite EMTR at one point in the income distribution).

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 with incomes above the Pay to Stay threshold would increase by 3ppts and 10ppts respectively. 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. Again by way of comparison, increasing all rates of income tax by 5p would raise the mean RR by 0.4ppts, and the mean PTR by 1.1ppts.

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 steeper the increase in social rents (and hence the larger the increase in government revenue and the more targeted rent subsidies are on those with the lowest incomes), the more Pay to Stay will tend to weaken the incentives of social tenants to be in work.

Table 1 collects some of 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.

Table 1. 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. Assumes no behavioural response. Mean work incentive measures for all social tenants aged 22–59. Change in exchequer revenue is the amount of extra rental income collected by local authorities (and hence passed to the Treasury) minus the small increase in housing benefit entitlements.
Source: Authors' calculations using Wilcox (2008), *Review of Council Housing Finance: Analysis of Rents*, London: Department for Communities and Local Government (http://webarchive.nationalarchives.gov.uk/20120919132719/http:/www.communities.gov.uk/documents/housing/pdf/1290130.pdf); 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.[6] But of course that would come at the inevitable cost of creating particularly weak work incentives for those who are on the taper (or who would be on the taper if they moved into work or increased their earnings).

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 the entire rent subsidy is withdrawn. This might have practical advantages over a taper – for example,

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[6] 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; the measure of income used is based only on the income of one member of a couple and hence it can create inequities between 1-earner and 2-earner couples; and the threshold at which the withdrawal begins is fixed in nominal terms over time (rather than uprated in line with prices or earnings).

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.[7] Since £30,000 of taxable income and £30,000 of after-tax income are quite different, 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. This highlights the oddity of specifying the level of the income threshold before confirming the definition of income to which it refers, and we recommend instead considering these design features jointly rather than sequentially. 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.[8] 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.

Finally, in addition to the design choices discussed above – some of which involve genuinely difficult tradeoffs – there is a far simpler point that is worth making. It is important that the Pay to Stay threshold does not join the growing list of parameters in the tax and benefit system that are simply frozen in cash terms over time by default. The government should decide how high this threshold should be relative to something economically meaningful like prices or

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[7] 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.

[8] See section 5.3.2 of Mirrlees et al. (2011), *Tax by design* (www.ifs.org.uk/publications/5353) for a detailed discussion of assessment based on before- versus after-tax income.

earnings, and should then keep it at that level, rather than allowing its value to be eroded arbitrarily over time.

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.

Universal credit

The effects of Pay to Stay will be different in a world with universal credit fully in place, because the knock-on consequences for benefit entitlements will be different.

Table 2 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 previously). A comparison with Table 1 reveals that universal credit slightly dampens the effect of Pay to Stay on the incomes and work incentives of social tenants. This is because 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, and hence will see an increase in benefit entitlement to cover some or all of the rent rise. Universal credit 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 some or all of the rent increase, so their work incentives would be unaffected or would be affected less.

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Table 2. 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

Notes and source: As for Table 1.

Universal credit will also reduce the impact of the introduction of a Pay to Stay taper on the incentive for social tenants to increase their earnings a little. The EMTR of most of those receiving support for their rents through universal credit 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 on 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.