Budget 2017: With demonetisation hitting homebuyers, rental housing needs to be promoted

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Recent government budgets have shown sincere appreciation for housing issues. However, the 2017 fiscal policy must be more realistic in acknowledging the undefeatal challenge of affordability. We must realise that housing and home buying are not synonymous. Renting deserves more attention.

Renters live under the risk of lease uncertainty, but save substantially compared to hom buyers. On the other hand, typical middle-class homebuyers build equity in their home but shell out hefty EMIs. Which of the two choices (renting versus buying) enhances welfare is not quite obvious. However, budget provisions are biased in favor of home buying affordability. The promotion of rental housing (e.g. the Habitat III report of MHUPA) is limited to "urban poor" and excludes the middle class.

Demonetisation, black money and home prices

Affordability, indeed, poses the largest challenge to home buying. Home prices have be shifting away from fundamentals partially due to the pervasive use of black money. Up 70 percent of the real estate transaction amount gets lost from the government's eyesig into the black market. Upcoming policy on benami properties will address this issue to some extent and discourage the demand generated from illegitimate wealth. All else equal, falling demand implies fall in prices. As a possible result of demonetisation, the vanishing black money will, at least, temporarily tame the demand and impede the pric growth.

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Chasing a mirage

However, whether the impact of demonetisation be sustained in a long rur questionable. The current policy initiative (e.g. reduction in the stamp duty, falling interest rate or 3 percent interest subsidy loans) are still geared towards increasing the demand for home buying. This will ac against what demonetisation is expected t achieve for affordability. Besides, we must not turn our blind eye towards the fact that over time with urbanisation, the urban land per capita will get scarcer and the demand housing will grow anyway.

So, if taming the demand is not feasible, will creating new supply do the trick? Scientifi studies in the past caution against the idea: the effect of increased supply may be subdued by the resulting demand stemming from the new economic activity (after all, real estate is nearly 10 percent of our GDP). Demonetisation is only a quick fix and the affordability issue is here to stay. In other words, irrespective of the (fiscal or monetary)policies we adopt, solving the affordability challenge while home buying is being incentivised is like chasing a mirage.

Affordability versus inadequacy

Our affordability measure stipulates home prices to be within five times the annual income and the EMI to be within 40 percent of the monthly income. With the prevalent loan terms, an upper-middle class household (with Rs 10 lakh income) can afford a Rs 50-lakh home (by the way, this scenario optimistically assumes that the household has already amassed Rs 10 lakh for the down payment). In New Delhi, this household could hardly afford a 1-bedroom flat with such money. Will that be adequate?

The Deepak Parekh Committee report (MHUPA) of 2008 pragmatically defines adequac for each income group in terms of physical attributes. However, the "adequate" middle class homes are selling in the range of Rs 70 lakh to Rs 1 crore. The numbers do not match. No wonder, the high income community is buying the middle income group (MI flats and the MIG finds it difficult to afford low income (LIG) flats. No one, not even the upper middle class, can afford to buy what is adequate. Long story short: we must look beyond affordability and take the issue of adequacy more seriously.

Renting versus buying

With much less monthly expenditure, renters may enjoy superior quality homes and localities. Thus, for a prudent household, renting implies a more adequate housing solution compared to home buying. Low rent-to-price ratio of residential properties lea to substantial savings by a renter. Compared to their home buying counterparts, even tl most risk-averse renters can amass superior wealth from these savings in the long run. The mobility afforded by renting leads to superior employment opportunities which enhances household welfare. Moreover, renting allows a household to flexibly consume its income within a lifetime. However, a home buyer will spend a large part of her lifetir paying for the EMIs. When the life is over, the wealth (home) is left behind, only partiall consumed. Renting, after all, is not a bad housing choice for the middle class.

Why is the rental market under-developed?

In the rental market, the tenants are under the classical fear of leasing risks. The lease contract is mostly dictated by the landlord who may increase the rents unpredictably or ask the tenant to move out undesirably. On the other hand, the landlords dislike the low yield (1-2 percent) on rental homes. Landlords also face financing and legal issues. For traditional flat developers, a large proportion of development capital comes from prospective homebuyers. Rental assets are devoid of such owners, thus making financir very difficult. Also, dealing with large number of erratic residential tenants is a judicial nightmare.

What could possibly be done?

In the long run, renters must be awarded superior tenure security and the landlords deserve support for generating superior yield. However, in the short run, the tenants deserve the much awaited attention from the budget which has been biased towards homebuyers.

a) Union Budget 2017

The promotion of home buying irrespective of the owner-occupancy status is a part of t problem. From the upcoming budget, renters deserve equitable treatment as awarded t homebuyers. The rental deduction limit of Rs 60,000 must be lifted and the renters should be able to fully deduct the rent expenses. This will help dilute the households' often financially irrational inclination towards home buying, but compensate them for t prevalent tenure insecurity. Such tax benefits, however, have to be "teasers" only (i.e. temporary, targeted only at spurring the rental demand).

b) Capital market solutions

Sebi must include provisions for and provide special tax status to residential REITs whi will support a healthy yield for owners. Besides, the NHB must consider refinancing rental property loans acquired by the developers. Facilitating such mortgage backed securities (MBS), particularly for the residential real estate sector, will reduce the cost and availability of debt financing to the rental property developers.

c) Promoting rental housing for middle class

The government must provide subsidies to the rental asset developers who retain the asset on their balance sheet, or the REITs who subsequently acquire it. The rental rates could be tied to market indices such as CPI to keep things fair (with appropriate measures for caps and floors to protect both the sides). The landlords must also be allowed to enforce additional covenants to protect the asset value.

d) Redefining adequacy: Longer lease terms

Above all, our definition of adequacy must include tenure security. Tenants should be allowed long term lease contracts with embedded options to terminate or the right of fi refusal. The landlords can price these real options into higher rental rate and improve their yield. Further, in leases with such tenure security options, the landlords should be able to delegate some burden of property tax, society fees and insurance to the tenants.

Must the government pay the cost?

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Promotion of rental housing will enhance the welfare and consumption in the middle class, infusing more rationality into our real estate system and thus generating more ta rupees. Creating a healthy competition between rental and for-sale housing segments will enhance the affordability for the households who genuinely need to be homeowner The need for new residential units (rental or for-sale) will sustain the real estate development and construction businesses which constitute the second largest part of o economy. With sufficient support, residential REITs or MBS will be a stable source of income to its unit holders who, in turn, will generate additional tax rupees.

With the demonetization move, the government has shown its ability to plan and implement bold policies. The outlook is optimistic.

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