ACA Submission to Prime Minister's Home Ownership Task Force

Introduction

The ACA recognizes the importance of reducing the cost of home ownership, and welcomes policies which will make housing more affordable.

Our emphasis in this submission is on initiatives which work through market mechanisms, rather than on subsidies to house buyers or financial institutions.

Any solution to the problem of housing affordability has to work on both demand and supply. There is a risk that policy makers will focus on financial innovations, rather than looking at more basic issues to do with the supply of housing.

Measures which focus on making more finance available to home buyers can be counter-productive. If more money is spent on a relatively fixed supply of housing, the result is likely to be a worsening of the price inflation which has already taken hold in the housing market.

This price inflation seems to have resulted from a convergence of many factors which have made housing attractive for investors, who are crowding out potential owner-occupiers. Falling nominal interest rates and, in recent times, the poor performance of equity markets, have made housing appear an attractive haven for small investors. Favourable tax treatment of investment housing – a permissive approach to "negative gearing", generous depreciation allowances, and changes in capital gains tax rules – have added to the attraction of housing as a financial investment. These factors have combined to provide a cycle of positive feedback of rising demand, rising prices and therefore the impression of ever-increasing capital gains.

If the Australian economy were healthier it would be easy for the Reserve Bank to prick the bubble with a small rise in official interest rates. Monetary policy is a blunt instrument, however, to deal with housing inflation. Australia's real interest rates are already high by world standards; a chronic weakness in our current account has required us to sustain relatively high interest rates to protect our fragile currency. Any further rise in interest rates would therefore weaken our investment performance even further.

In the long term the most sustainable way of ensuring housing affordability is to overcome structural weaknesses in the Australian economy and to reform the tax system to encourage real investment rather than speculation and rent-seeking behaviour. Housing ownership in Australia peaked in the mid 1960s, after a period of sustained growth – growth which had seen its benefits widely distributed. By contrast, the growth of recent years has been lopsided, characterized by widening income disparities, making home ownership more difficult for the poor and speculative investment easier for the rich. In a more robust and internationally competitive economy the benefits of growth would be better distributed through higher-paying jobs and a more even distribution of incomes. With steadier growth, less dependent on commodity cycles, lower real interest rates could be sustained.

Therefore we stress that solutions to the present problem of housing affordability should not substitute for attention to long-term structural reform of the Australian economy. But there is an immediate problem, and we suggest a conventional demand/supply approach:

> On the *demand* side, withdrawal of some of the measures which place investor housing in a privileged position. Such moves could prick the housing bubble, releasing a large amount of speculative housing onto the retail market. The benefits should flow through to purchasers within a few months.
>
> On the *supply* side, development of regional and settlement policies which ease the pressure on our major cities, particularly Sydney, Melbourne, Brisbane and Perth. We classify these as "supply" side, because they relate to supply of infrastructure, employment opportunities and urban amenities. Such policies will require the cooperation of all tiers of government, and, given the lead time for planning and provision of infrastructure, they have to be considered as medium term solutions.

In sum, we suggest three policy approaches, corresponding to three time frames:

> Long term – restoration of economic strength, international competitiveness and balanced growth, with low real interest rates and taxation policies supportive of real investment.
>
> Medium term – regional and settlement policies which take pressure off state capital cities and adjoining coastal regions.
>
> Short term – releasing housing to home buyers through removing distortions which have placed too much housing into the hands of speculators.

We expand on the short term and medium term approaches below.

Short term – remove distortions from markets

Housing price inflation

House price inflation has not been uniform. Price changes in project houses have been modest. For established homes[1], however, there have been significant price rises, particularly in the faster-growing state capitals – Sydney, Melbourne, Brisbane and Perth – which hold 55 percent of Australia's population. The faster rise in Melbourne prices is a recent phenomenon.

These movements are shown in Table 1 which covers a 16 year period. While housing price inflation has accelerated in the past two years, it is not a recent phenomenon.

[1] Our terminology "houses" and "homes" follows the ABS convention of calling established houses "homes".

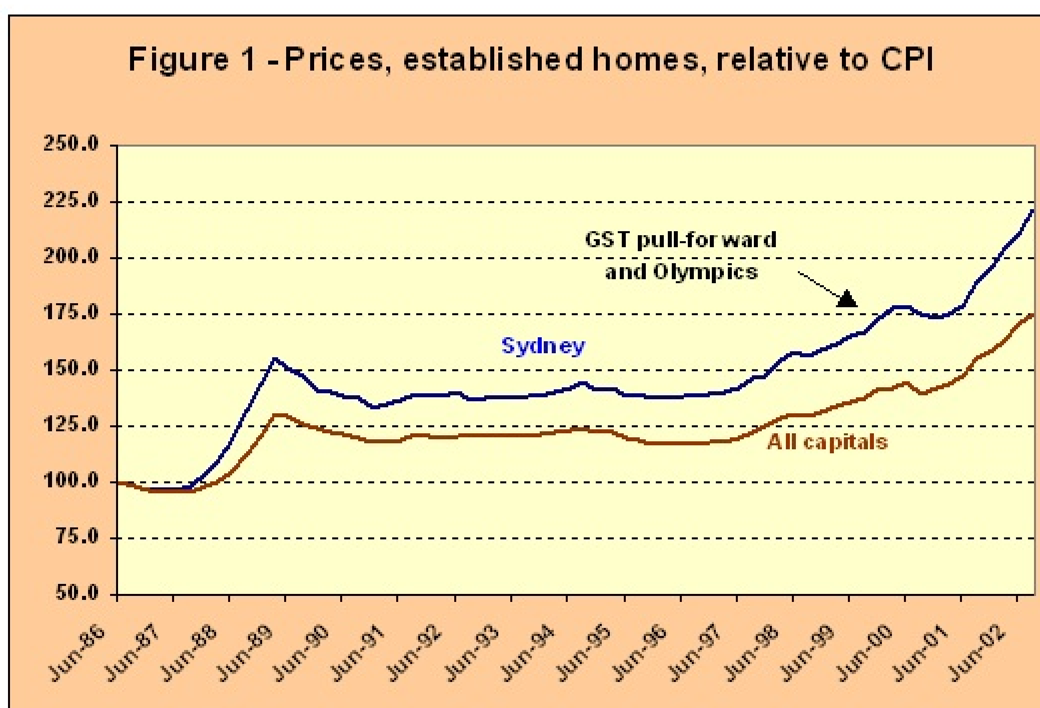
Table 1 – Real price increases, percent, June 1986 to September 2002

	Project houses	Established homes
Sydney	23	121
Melbourne	6	79
Brisbane	16	64
Adelaide	-3	11
Perth	5	50
Hobart	2	1
Darwin	27	17
Canberra	9	31
Average (weighted)	11	75

(Nominal price increases deflated by CPI - statistical series available only from 1986.)

There are qualifications relating to ABS data on house prices. Prices are surveyed for free-standing houses only. Prices of project houses refer to houses only; prices for established homes include land. That means the steep rise in established home prices relative to project house prices is likely to reflect land price increases. And, while care is taken to account for quality changes in project houses, prices for established homes can be influenced, to an extent, by quality changes which are difficult to factor out.

The rise has not been steady. There have been periods of steep growth and of falling *real* house prices – masked, to an extent, by inflation, for there are few instances, in Australia so far, of falls in *nominal* prices. (In some countries, such as Japan and Hong Kong, even nominal house prices have fallen at times.) The present bout of strong rises in house prices started in mid 2001.

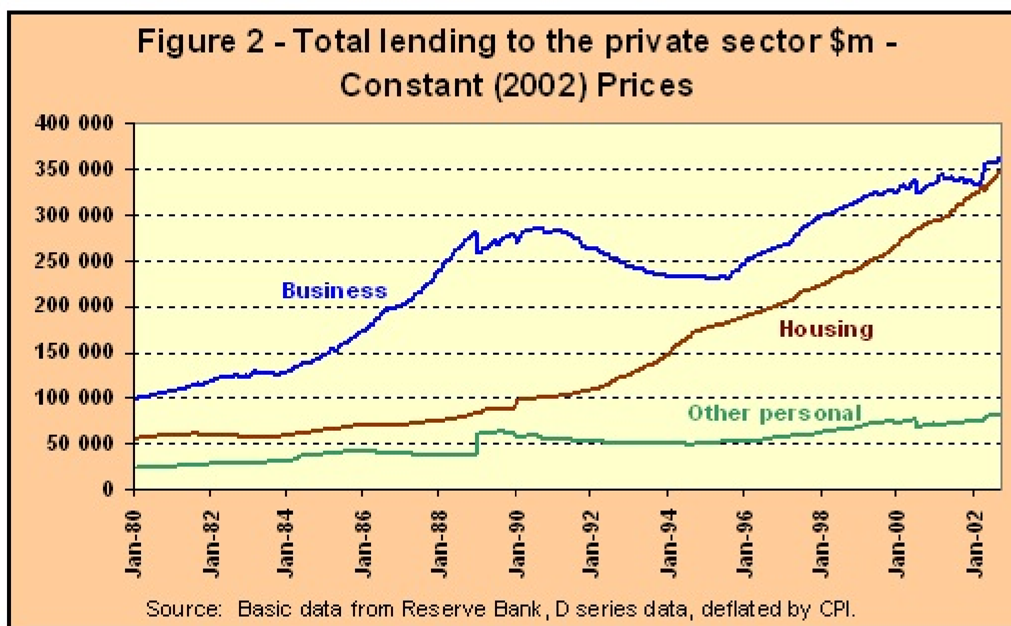


Drivers – financial

The proximate driver of housing prices seems to be the availability of finance. The Reserve Bank explains that in the 1990s banks and other financial institutions sought to expand their portfolios of housing loans. Over the 1980s, as many companies over-extended their borrowing, corporate lending became more risky. Financial institutions saw lending for housing as a way to reduce the overall risk of their portfolios.[2] Also over the 1990s the other large low-risk market, the government bond market, was shrinking. The government bond market fell from around ten percent of financial institution lending in the early 90s to around four percent in 2000.

In the mid nineties, two initiatives by financial institutions significantly boosted lending for housing. They reduced the spread between the cash rate and housing lending, and abolished a premium, which had been between 1.0 and 1.5 percent, for loans to housing investors (as opposed to owner-occupiers). Other initiatives, such as home equity loans, split-purpose loans, interest-only loans (which take advantage of tax concessions on interest) and deposit bonds (which remove a cash hurdle for investment) have made housing even more attractive for investors; it is now possible for an investor to enter the housing market with no cash deposit.

But, it should be noted, the growth in lending for housing is not a recent phenomenon. In constant prices, housing lending doubled over the 1980s, before doubling again over the 1990s, as is shown in Figure 2. The growth in housing lending started with financial market deregulation in the early 1990s, which resulted in much more substantial competition in the residential housing finance market.



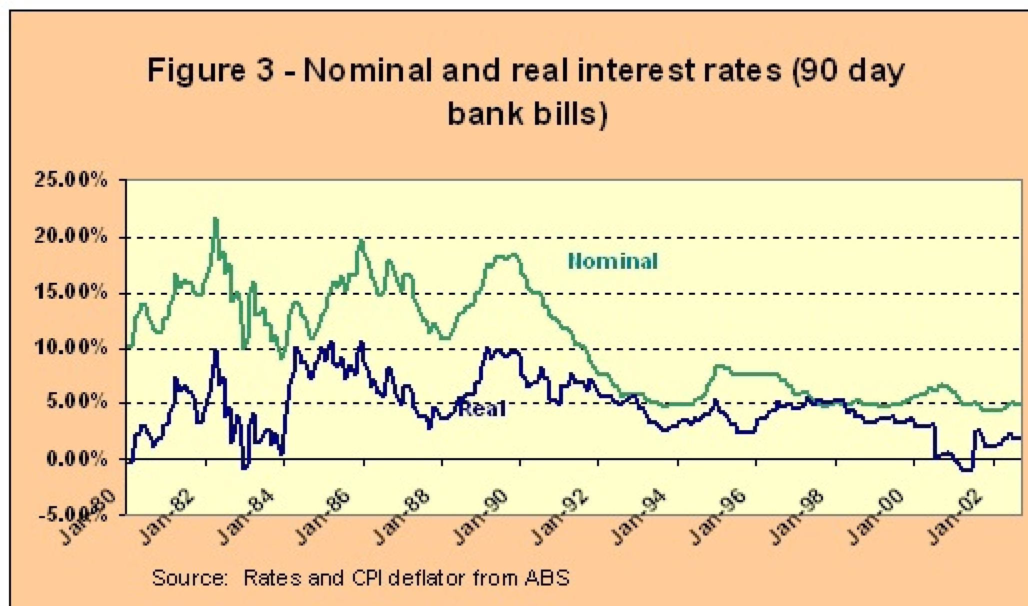
2 Reserve Bank *Innovations in the Provision of Finance for Investor Housing* December 2002.

Incentives

Housing has become attractive for investors for a number of reasons, some arising from the operation of financial markets, others arising from government policies.

While real interest rates in Australia have remained reasonably high over most of the last twenty years, nominal interest rates have fallen steadily over the 1990s. Real rates have generally been around five percent; only since around 1999, as fears of a global recession emerged, have they fallen. This fall is shown in Figure 3, showing, as an indicator, real and nominal returns on 90 day bank bills. The premium for housing lending is around two to three percent, but because it has been higher in recent times the decline in rates shown in Figure 3 is understated as far as housing is concerned. (The temporary fall in real rates in the late 1990s is an artefact caused by the boost in the CPI following introduction of the GST.)

Reasonably, we would expect the demand for housing finance to respond to real interest rates. But investor rationality is elusive, particularly when financiers and politicians alike talk only about nominal rates. Investors and owner-occupiers alike are likely to base their decisions not only on real rates, but also on the affordability of repayments. Immediate affordability is governed by nominal, rather than real interest rates. (In times past, when inflation and therefore nominal rates were higher, those who bought housing could reasonably expect the real value of their housing loans to shrink rapidly. Now, in an era of low inflation, the burden of loan repayment is likely to linger for some time.)



Another development making housing investment attractive has been the reversal in the fortunes of equity markets. Recent falls in foreign equity markets have been sharp, and, while Australian stock prices have not fallen so heavily, they are now much less attractive for investors than they were in the mid 1990s. Housing, therefore, provides an attractive option for small investors, particularly if they are influenced by the impression of sustained capital gains and disillusioned by the performance of other investments. In 2001 property outperformed other classes of domestic investment – shown in Table 2.

Table 2 – Percentage returns on assets

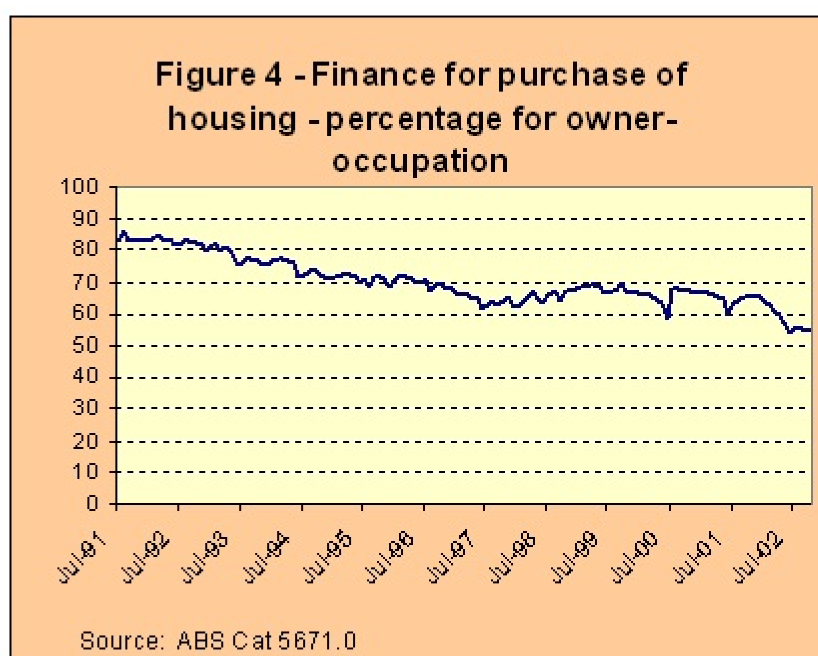
	Nominal 2001	Average 1985-2001 Nominal	Real
Australian equities	10.4	14.0	9.5
Listed property securities	14.6	12.3	7.8
Direct property investment	10.4	9.0	4.6
Fixed interest	5.5	11.6	7.1
Cash (bank bill)	5.2	9.8	5.4
Govt bond 10 year	6.0	9.6	5.2

Source: Base data from JB Were Oct 2002, Govt bond and CPI for conversion to real returns from ABS

It is notable that in the 1980s, while equity prices fell in late 1987, the housing market did not fall for another two years. Following collapse in the stock market there was a flight to real estate. There could be a similar effect occurring now.

Besides these trends in financial markets, over the eighties and nineties the policy climate for housing investors has been very positive. In 1985 a depreciation allowance of 4.0 percent for investor housing was introduced. This was reduced to 2.5 percent in 1987, when "negative gearing" for housing was reinstated. Then, in 2000, the Ralph "reforms" to capital gain taxation were introduced.

In permitting tax deductibility of both depreciation and interest, there is a degree of over-compensation for investors, for part of the interest payment – the inflationary component – is really a capital repayment. Interest-only loans, which are becoming increasingly popular, take particular advantage of this distortion.



It is easy to demonstrate that the favourable tax treatment given to housing investment, even without recourse to creative financing options such as home equity loans and interest-only loans, results in a capital subsidy in the order of 40 to 50 percent – basically because, following the Ralph "reforms" the tax on the ultimate capital gain is so low and does not re-coup the accumulated generous deductions for interest and depreciation. When investor equity can be reduced through contrivances such as deposit bonds, the subsidy is even greater.

The result of all these incentives – some arising from the market, some from government policy – has been a fundamental change in the nature of housing finance. Just ten years ago more than 80 percent of housing lending was for owner-occupied housing. That proportion is now just over 50 percent.

Recommendation

These developments provide an opportunity for the Commonwealth to review tax allowances applied to investment in housing. The Commonwealth could revert to a form of capital gain taxation which is neutral between different forms of income – that is, the regime which existed before the Ralph "reforms". (In removing a bias which favours short-term/high-growth speculative investment, its benefits could flow through to other sectors of the economy.)

A more modest change could be to allow tax deductions on interest payments on only the real component of interest, thus avoiding the double-counting of capital allowances (i.e. deduction on depreciation and the real component of interest). An even more modest change would be to disallow tax deductions for "negative gearing" and other creative financing options, such as home equity loans and split purpose loans. They would all be ways of pricking the housing bubble, resulting in an expansion of supply of housing as investors sell part of their stock and as other potential investors look to markets other than real estate. A by-product of such initiatives would be protection of public revenue from tax-minimization contrivances associated with housing.

Clearly such changes would meet some resistance from investors who have benefited from the generous breaks for housing investment. But in the long term very few benefit from housing becoming unaffordable, and, if such changes help correct distortions in capital markets then investors should be compensated by higher returns from other assets.

If, however, the Commonwealth lacks the political courage to make these modest reforms, then perhaps the best option is to do nothing. Rental yields are already dropping, auction clearance rates are falling, and there is still a large amount of housing under construction, particularly apartments.

Also, Australia is getting over the second round baby boom. The period from 1971 to 2001 has seen a strong growth in the population aged 21-30 – the cohort most likely to be establishing a household – which grew by about a million over that period. That group is now stabilizing as shown in Table 3.

Table 3 – Population aged 21-30

	Population 21-30, million	Percentage of total population
1971	2.06	15.7
1981	2.51	16.8
1991	2.80	16.2
2001	2.87	14.8
2011	2.92	13.7
2021	3.00	13.1
2031	2.89	11.9
2041	2.88	11.5
2051	2.94	11.6

Figures from 2011 onwards are ABS mid-scenario projections

Reverse mortgages

Reverse mortgages, which involve a financial institution becoming an equity holder in a residential property, have been raised in the context of this inquiry.

They may have some relevance for older people with highly-valued real estate, who have a shortage of liquidity, no great desire for endowment to the next generation, and who do not wish to shift. It is difficult to see their relevance, however, in terms of housing affordability for younger people. In fact, if reverse mortgages were to be effective in helping older people to remain in their houses, they could actually lessen the supply of suitably-located houses available to others.

If they are to serve a role for older people, then the main concern of governments should be the transaction costs, both on establishment of a reverse mortgage and on final discharge, when the house is eventually sold.

On a macroeconomic scale, if the purpose of reverse mortgages is to convert non-liquid assets to cash, then perhaps governments should consider inclusion of owner-occupied housing in the capital-gains tax regime. In this way at least some of the value increase, which often results from the externalities of public investment, can be returned to the community.

Medium term – regional and settlement policies

A Melbourne and Sydney problem?

Although official statistics on housing prices relate only to capital cities, a glance in the window of a real-estate agent's office in a country town is enough to confirm that the problem of housing price inflation is confined to certain regions.

In general, Australia's population is continuing to concentrate in capital cities and coastal regions. Within capital cities, there has been high growth in the population of inner urban areas – albeit from a very low base. Over the ten years to 2001 the population of the City of Sydney rose from 7 000 to 32 000, and the population of the City of Melbourne rose from

35 000 to 52 000. Combining the figures for the two cities, there was a doubling of population over the 90s. These inner-city developments account for about 13 percent of the population growth of those two cities. There has also been a combination of coastal and capital city demand with coastal regions within capital cities seeing very high population growth.

With a few exceptions, such as large inland service cities drawing population from their hinterlands, and some mining settlements, the inland population of Australia is declining.

Price rises have a reasonably strong association with population growth. Figure 5 is a re-presentation of the data in Table 1, with the addition of growth rates for the relevant cities. Unsurprisingly, for most cities, population growth and housing price risess are closely related. (Darwin is off the trend line, but its absolute population growth over the decade has been only 22 000.)

Sydney and Melbourne are also off the trend line, in the opposite direction. There are factors other than population growth which explain the phenomenon in these cities.

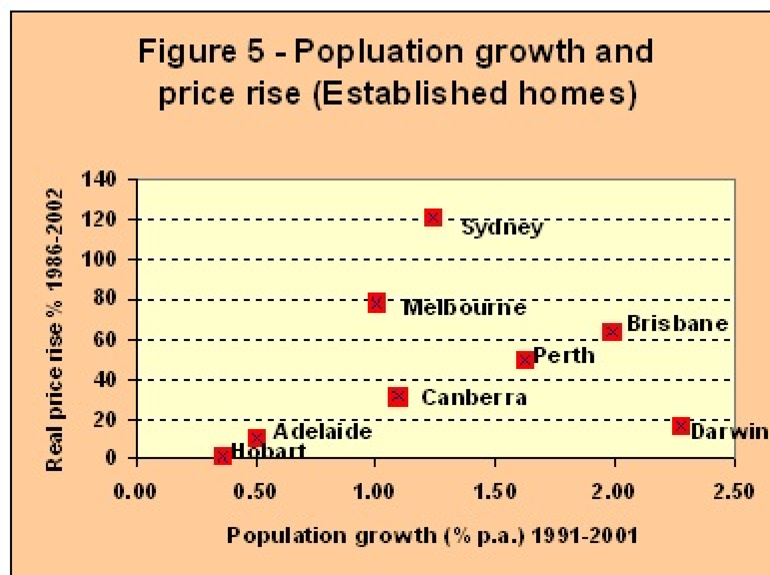


Figure 5 - Popluation growth and price rise (Established homes)

There is insufficient data to draw categorical conclusions about the reasons for the particular problems of Sydney and Melbourne. There may be a "home bias" among investors; because of easy availability of knowledge (low search costs), easy supervision and low transaction costs investors prefer to invest in their own cities.

A similar "home bias", together with the advantages offered by economies of agglomeration, have probably influenced firms in their location decisions. In a positive feedback spiral, employment opportunities accumulate where people are already concentrated.

Another strong possibility is that there is a spatial misallocation of resources within these cities. In Sydney and Melbourne not only have price increases been the highest, but also the disparity in price rises between established homes and project houses has been greatest. This would be consistent with real-estate agents' anecdotes about the high demand for housing close to the city precincts.

In the last twenty years a great deal of effort has gone into improving Australia's central cities (CBDs and surrounding precincts). Australia has fortunately avoided the US phenomenon of urban blight – largely thanks to well-established fiscal arrangements which have prevented the positive feedback loop of middle-class flight and a declining tax base. Urban renewal in

Australia is dominated by apartment construction. A by-product of these developments, however, has been that the relative attraction of living close to the CBDs has risen.

By contrast the picture in the outer suburbs is mixed. Some have become enclaves of the well-off, similar to suburbs in the US, but for the most part their role is to provide housing for those who cannot afford the amenity of living closer to places of employment, education and recreation. Those who live in such regions often have to bear long commuting distances, becoming worse because of underdeveloped transport infrastructure (giving rise to associated externalities in congestion and pollution).

In short, housing supply is restricted because there is a shortage of locations where people want to live and where firms want to invest, the two being closely related. There is some capacity for urban infill, but there is a limit to the potential for increasing urban density, without putting severe strains on services such as electricity, water supply, sewerage, recreation space and transport. These urban areas near city centres have all the characteristics of positional goods – that is, a finite supply for which extra demand inevitably results in price inflation.

While this situation persists, outer-suburban dwellers are unlikely to enjoy the benefits of significant capital gains; in fact, there is the strong possibility of real capital losses. This means wealth inequities could worsen.

Furthermore, labour market mobility could suffer if there are wide disparities in housing prices. Already that many middle-aged people are trapped in unemployment or poorly-paid occupations in country towns because they have too little housing wealth to establish themselves in another, more prosperous region.

Towards regional policies

Relief of this pressure will require a set of related policies, mainly under the control of state and local governments. They relate to provision of public transport, roads, education institutions, public recreation services, open space, public safety, health care institutions and other government services. In all these services quality is an important determinant in attracting firms to invest and people to live in particular regions. There is already some progress in developing peripheral (rather than radial) roads and public transport services serving urban fringes, but this progress is glacially slow.

When it comes to development outside the state capitals, we are still no further advanced than we were twenty years ago. Admittedly, the last ten years have seen equality in the growth rates of the eight state capitals and the rest of Australia, but this is still haphazard and unplanned. Much of what is statistically classified as outside the state capitals is reasonably contiguous with the capitals (Gold Coast, Wyong, Victor Harbor etc). And some is along a narrow strip of coastal New South Wales and Queensland, where, in places such as Port Douglas and Noosa Heads, housing price inflation has been just as strong as in Sydney and Melbourne. By contrast, rural regions and many non-capital urban regions – such as North East Tasmania, the Latrobe Valley, South Australia's "Iron Triangle" – are suffering low growth or even population decline.

Australia has had regional policies in the past. They have not always been well-designed, however. Generally, they were centred on attracting firms in selected industries (particularly manufacturing) to designated growth centres. They have shown some dividends, but for the most part they were half-hearted and misdirected. There was too much emphasis on subsidies for particular firms, the benefits of which lasted only so long as the firms stayed in business. By contrast there was too little attention to public goods which only governments can supply, particularly transport infrastructure. Some of the growth centres on the 1970s and 1980s are now stranded without adequate road or rail connections.

It is time to re-consider the need for regional policies. The current fashionable term "rural and regional" is little more than a vague and ill-defined phrase, chosen, perhaps, more for alliteration than for conveying any precise meaning. And there is little policy consideration of regions with urban areas – regions are something "out there".

Regional policies need to be based on sound research and need to integrate the policies of all tiers of government, particularly transport and other infrastructure policies. There is strong evidence that development occurs along corridors of transport infrastructure. This being so provision of such infrastructure needs to be based on careful planning, rather than *ex post* and *ad hoc* reaction to emerging bottlenecks. In relation to coastal developments, all tiers of governments should work together to prevent uncontrolled sprawl, ensuring growth is concentrated in certain nodes well-served with transport, education and health care services.

Proper regional planning should take into account the environmental sustainability of regional development – avoiding, for example, the development of large population nodes on the headwaters of inland drainage systems or sensitive coastal environments.

If governments want to go beyond such generally-available measures, then they may wish to consider support for particular industries rather than individual firms, in recognition of the benefits which can flow from regional clustering. Such support could involve, for example, funding of cooperative research centres.

Regional programs are not cost-free, but states should be able to find the funds within their budgets, particularly their development budgets which are often squandered on competitive bidding for industrial projects. Neglect of regional issues results in very high costs, including environmental degradation and the need to retrofit public infrastructure.

Technical solutions

The most promising policies are to do with improving market structures – relieving the price pressure from investors and increasing the supply of locations where people may wish to live and work. But it is also worthwhile to consider the possibility of some technical initiatives which may make housing more affordable.

One is reform in the nature of the building and construction industry. Commonwealth policies have tended to focus on proximate issues to do with labour relations in the industry. But it is possible that poor labour relations are a consequence of the way in which the building and construction industry is subject to such large swings in fortune. Much of the brunt of the business cycle is borne by the building and construction industry. If the future is

uncertain there is little incentive to invest in capital equipment, staff development, or in the personnel practices which make for harmonious working relationships.

Rather than relying solely on the crude instruments of monetary policy to stabilize the economy, with such a heavy burden falling on the building and construction industry, it could be useful for the government to consider counter-cyclical fiscal measures which could help stabilize the industry. For example, construction of public housing during downturns in private markets and considered timing for the construction of public infrastructure could help stabilize the industry against the swings in fortunes of private markets.

State governments also have some responsibility for costs borne by home buyers. Stamp duties are very regressive forms of taxation, for example. For greenfields developments, state and local governments need to be wary of the opportunity for exorbitant profit-making by property developers. And all governments, through their competition and consumer protection agencies, need to keep a close eye on the bureaucratic overheads associated with real-estate transactions, particularly the fees and services of lawyers, financiers and real-estate agents.

If the population is becoming more mobile, or even if people feel they need to be more mobile because of job insecurity, it is important to pay attention to these transaction costs. If shifting house is a once-in-a-lifetime activity, then these costs can be amortized over a long period, but in a more mobile population they provide a strong disincentive for buying a house.

Although most of these costs are primarily under the influence of state governments, one minor initiative which the Commonwealth could consider is the treatment of rental income for those who let their own house while on a temporary work or study placement elsewhere. It would seem reasonable that in such situations people be permitted, for income tax purposes, to offset the rent received against rent outlaid.

Conclusion

This submission has focussed on removing market distortions, thus allowing the housing market to return to something more resembling equilibrium. Investors in real estate, encouraged by financial market developments and a very favourable taxation regime, have tended to crowd out the market for well-located real estate. Even if the Commonwealth lacks the political will to remove the subsidies for real estate investment, there are signs that oversupply is emerging, which, in the short term, will bring prices down to some degree.

In the medium term there is a need for Australia to adopt spatial policies which make for a more even distribution of population. While Australia's cities are among the world's most livable, other regions, including some of the peripheral urban regions, are far less appealing. Well-researched policies are needed if these regions are to play a part in housing supply. Otherwise Australia faces a phenomenon of rural and outer-suburban blight.

In the longer term equity in access to housing will be served best by more balanced growth, in an internationally economy in which all Australians can earn enough to sustain a decent standard of housing, without having to compete with a privileged elite whose excess income is diverted into investment housing.