Productivity Commission Inquiry into First Home Ownership
Australian Consumers' Association Submission

Introduction – ACA's interests

There is no need to stress the importance of housing affordability. High prices freeze deprive many people of the private and community benefits of ownership. There are clear links between housing ownership and relief from poverty.

Those who can buy in an over-priced market face the burden of high mortgage repayments, and risk losing equity in any subsequent price downturn. Although some fortunate few can profit from an asset bubble, for the vast majority of purchasers and investors the consequences of a boom/bust cycle are negative.

While this inquiry is concerned with first home ownership, affordability is also an issue for those who choose to rent, for sustained high house prices are likely to flow through to rental costs – even though there may be some temporary relief in periods of over-supply. And for those who wish to change housing, because of work or changes in needs, transaction costs in moving to more appropriate housing can impose a major burden. Because many transaction costs are related to price, high house prices lead to high transaction costs. Immobility imposed by high transaction costs can result in poor resource allocation, in terms of inappropriate housing for people's life stages, reluctance to move to better employment, and increased travel costs.

The Commission has been directed to pay particular attention to a number of supply side factors which affect housing costs. While these factors are, indeed, important, the Commission should also consider demand side factors, particularly those which have encouraged a high supply of funds into housing. In any market with a degree of supply inelasticity, an increase in funding is bound to raise prices, regardless of cost factors.

Any proposed solutions should address not only immediate issues, but also medium and long term issues, including regional policies, environmental sustainability and infrastructure provision. There is strong evidence that continued growth of Australia's state capitals will be very costly.

This submission urges the Commission to examine a number of broad issues. The first part examines the evidence of house price inflation. This is followed by consideration of cost or supply-side developments which may have contributed to housing price inflation. The third part focusses on demand side developments, particularly favourable taxation treatment for investor housing, which have contributed to housing inflation and innovations in the manufacture and distribution of home lending products. While some interested parties have stressed single causes, particularly supply side causes such as state taxes, we believe there are many interacting causes, and there is no single solution.

1. Housing inflation – the evidence

House price inflation has not been uniform. Real (CPI adjusted) 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.

These movements are shown in Table 1 which covers the 17 year period the ABS has been monitoring house prices.

Table 1 – Real (CPI deflated) price increases, percent, June 1986 to June 2003

	Project houses	Established homes
Sydney	23	147
Melbourne	10	92
Brisbane	22	93
Adelaide	-2	28
Perth	8	66
Hobart	9	12
Darwin	29	20
Canberra	15	52
Average (weighted)	14	96

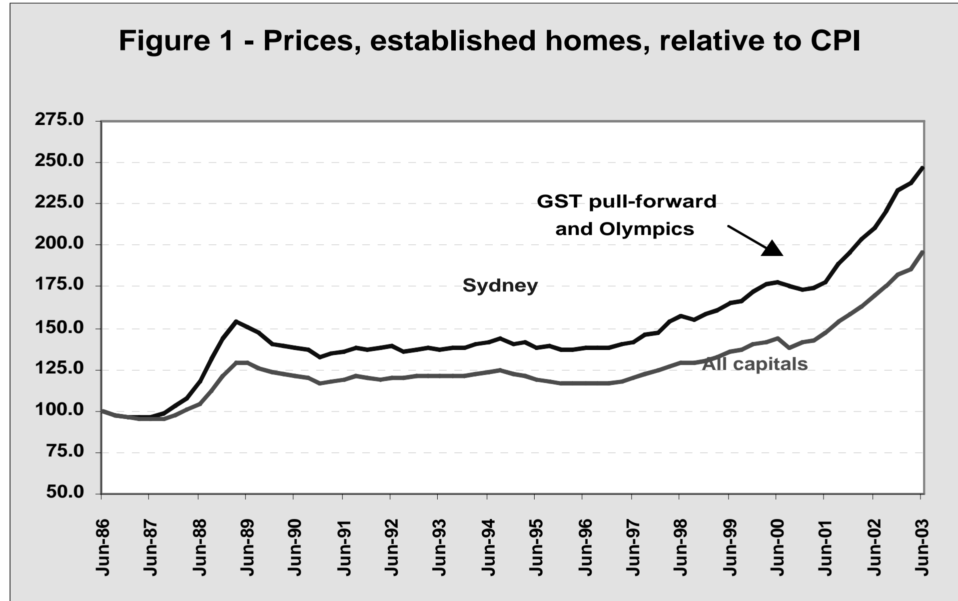
(Nominal price increases deflated by CPI – statistical series available only from 1986.)

It could be argued that CPI adjustment simply compares house prices with other goods and services. Affordability, on the other hand, relates to earning.

A series related to average earnings is shown in Table 2. This still shows strong real price growth – a 65 percent rise nationally and a more than doubling for Sydney, with respect to average earnings. In any event, indexation to average earnings is likely to understate the affordability problem, because in a period of growing earning inequality average earnings have almost certainly risen faster than earnings for first home buyers.

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

Table 2 – Real (AWE deflated) price increases, percent, June 1986 to June 2003



	Project houses	Established homes
Sydney	4	109
Melbourne	-7	62
Brisbane	3	63
Adelaide	–17	8
Perth	-9	40
Hobart	-8	-6
Darwin	9	2
Canberra	-3	28
Average (weighted)	-4	65

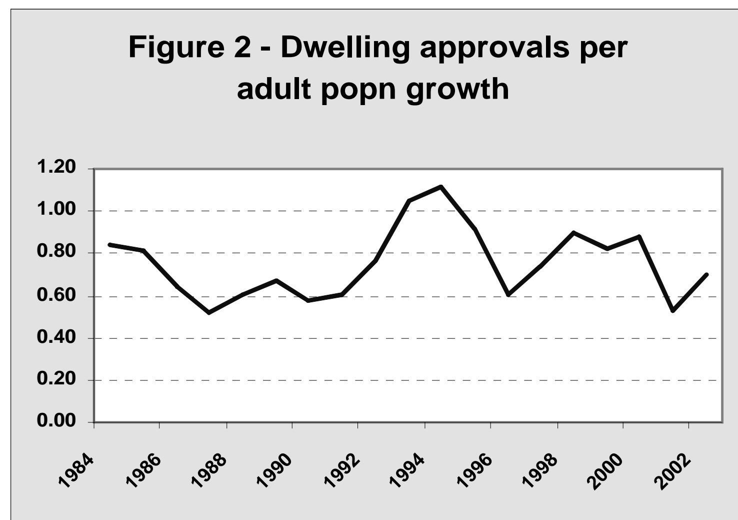
(Nominal price increases deflated by AWE full time adults.)

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. And, while the ABS takes care 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 steep rise in established home prices relative to project house prices is likely to reflect land price increases. The modest real price rise of project homes (a fall in relation to earnings) does not suggest building costs are a contributing factor. It would be useful, however, for the Commission to inquire why there has not been a productivity-related fall in

project house prices. Assuming a 70 percent labour component in building costs, a two percent annual labour productivity improvement over this period would result in a real price fall of twenty percent; a one percent productivity annual productivity improvement would result in a real price fall of ten percent.

Recommendation: That the Commission report on productivity developments in provision of houses and associated infrastructure, identifying, if possible, any productivity opportunities not taken up.



The rise in house prices 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's recent history, of falls in nominal prices. The most recent real price falls in Australia were the late 1970s and early 1980s, a period of high inflation (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. It is notable that both recent booms have started after heavy falls in equity markets in 1986 and 2001, a point to which we return in Part 3.

2. Supply and cost factors

Supply of housing

One factor which can contribute to a high rise in prices is constrained supply. There have been suggestions that the most appropriate policy response to the current problems is for state and local governments to release more land for subdivision.

Nationally there is not strong evidence of a supply crisis. We have examined ABS time series for dwelling approvals and growth in Australia's population over 18 years. From these we have derived the ratio of approvals to growth in that population. That time series is shown in the graph alongside.

In 2002, that ratio was at 0.70 – that is one new dwelling approved for every 1.4 persons – a little below its eighteen year average of 0.73. While 2002-03 population details are not available, dwelling approval figures are available, indicating that the strong level of 2001-02 is being maintained.

We may expect some slight rise in this ratio as the number of people per household falls; over the period 1984 to 1998 that number fell by nine percent, from 2.84 to 2.60. But there is no

evidence from these figures of a chronic national supply shortage – the ratio of supply to population growth does not indicate a problem.

Looking longer term, specifically at the population aged 21 to 30, the cohort most likely to be first home buyers, we see a rapid fall in the growth of that age group over the last twenty years, and, within the next thirty years, a possible contraction in that age group. This indicates some significant reduction in demand for first homes. (A reduction in demand, in itself, does not indicate an elimination of the problem, if people are living longer and not releasing housing on to the

Table 3 – Population aged 21-30

	Population 21-30, million	Percentage of total population	Growth over ten year period, million
1971	2.06	15.7	
1981	2.51	16.8	0.45
1991	2.80	16.2	0.29
2001	2.87	14.8	0.07
2011	2.92	13.7	0.05
2021	3.00	13.1	0.08
2031	2.89	11.9	-0.11
2041	2.88	11.5	-0.11
2051	2.94	11.6	0.06

Figures from 2011 onwards are ABS mid-scenario projections

While not wishing to downplay the seriousness of current problems, we see long term consequences if there is a national policy response which results in oversupply, which could leave many house buyers with rapidly falling prices many stranded in subdivisions which never become fully developed.

That is not to deny the possibility of regional problems, such as particular problems in Sydney and other capitals.

Regional developments

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 period 1991 to 2002 the population of the City of Sydney rose from 7 000 to 31 000, and the population of the City of Melbourne rose from 35 000 to 54 000. Because Brisbane City covers a large area, it is not possible to find a firm figure for inner urban population growth, but the apartment developments along and near Brisbane River confirm there has been very strong growth there as well. 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 3 shows real (CPI adjusted) house prices over the period 1991 to 2002, plotted against the annual population growth rates for the relevant cities. For most cities, population growth and housing price rises are closely related. This suggests some stickiness in supply catching up with demand; it could also be indicative of either high costs in those locations or a fundamental imbalance in supply and demand.

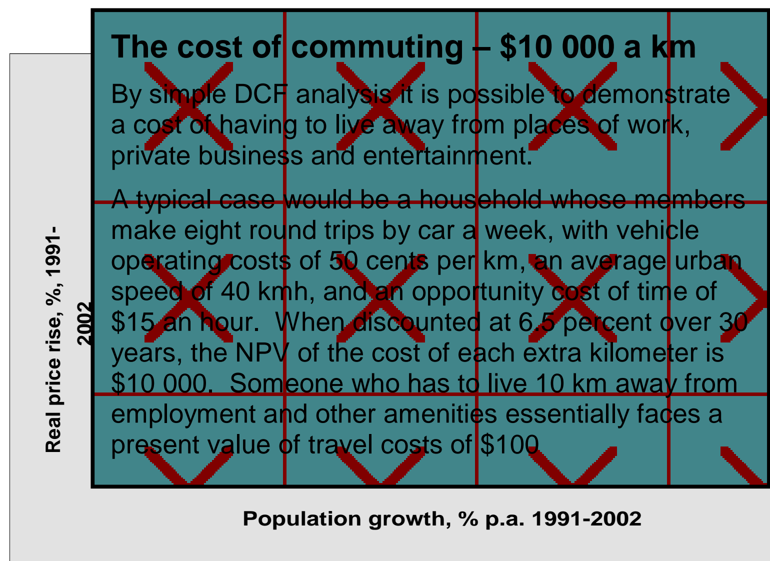
Sydney and Melbourne are above the trend line, in spite of those cities not having had high rates of population growth. (But in both cities there has been strong population growth in regions outside their defined statistical divisions.)

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. (See Table 1.) This would be consistent with real-estate agents' anecdotes about high demand for housing close to the city precincts, because project houses tend to be built on the periphery.

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.

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). Savings in house purchase prices are generally more than offset by commuting costs (see box) – an expensive and wasteful form of time payment. And those costs are only the private costs; they do not include the community costs of congestion, pollution and provision of road space.



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. 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 our inner-city areas become more attractive compared with fringe areas, outer-suburban dwellers are unlikely to enjoy the benefits of significant capital gains; in fact, there is the strong possibility of real capital losses as populations stabilize. This means housing wealth inequities could worsen unless the relative disadvantages of outer suburban living are ameliorated.

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 with better employment prospects.

> *Recommendation: That the Commission report on the economic costs (foregone productive employment) resulting in regional disparities in housing values.*

Cost factors

Undoubtedly there will be many submissions to the inquiry covering cost factors, particularly stamp duty.

Stamp duty fails many of the tests of what constitutes a good tax. The ACA has been wary about Australia shifting tax balance – from a progressive income tax toward more regressive consumption taxes. Stamp duty is even more iniquitous than GST, because it is imposed before "consumption" even commences – a house is an asset which goes on providing imputed rental services for many years. It is imposed on those who have little capacity to pay, and, to the extent that it discourages expenditure on housing, it imposes a deadweight loss.

There has been less publicity given to other costs, however. The Housing Industry Association (HIA) illustrates that state taxes are only part of the costs loaded on to housing costs. Their table of costs, for a Sydney greenfield development, is shown in Table 4. And that table may understate the situation, for not shown in that table are solicitors and agents' fees. One could argue that agents' fees are borne by the seller, but, particularly for established houses, they come to be passed through to buyers.

> *Recommendation: That the Commission report on the level of private sector fees associated with house purchase, including those of agents, financiers, developers and solicitors, with a view to identifying any possible economies.*

Table 4 – Cost elements in a Sydney greenfield development

	Percent
Land	29
Dwelling	24
State tax	12

Local government tax	11
Federal tax	8
Local developer margin	8
Bank fees and charges	4
Builder margin	4
	100

Source: HIA "Restoring housing affordability", July 2003, p. 16

The HIA refers to many government charges as "taxes". Taxes, by definition, are not linked to specific provision of goods and services. Some of the items identified by the HIA are charges for infrastructure. A reclassification does not lessen their impact, but if the infrastructure is necessary, is being provided as efficiently as possible, and is being charged at reasonable prices, then it would not be economically responsible to seek relief from imposition of a charge.

Recommendation: That fees set by governments clearly differentiate between taxes and fees for infrastructure and other services. Fees should be clearly identified, and linked to specific infrastructure and other services.

While tax relief is desirable, the ACA does not necessarily seek relief from reasonable fees. What would be more reasonable than seeking relief, is for charges for infrastructure to be levied over time, rather than upfront. State and local governments may respond that they need cash to provide these services, but, there is no reason they cannot finance this infrastructure from borrowing, to be repaid over time. This would result in an overall lower finance cost to house buyers, for at present they are generally financed at private interest rates through mortgages, rather than at lower government rates.

An impediment to such an approach to funding is the notion that public sector debt is intrinsically undesirable. The Commission could help by using its economic authority by countering this notion.

Recommendation: That charges for infrastructure and other land services be spread over time. Initial finance should be financed by government borrowing.

A more basic question is not whether present fees are reasonable, but, rather, whether expansion of existing cities represents the most efficient use of resources. Expansion on the peripheries of cities imposes large costs on existing urban infrastructure, including urban railroads, trunk roads, water supply and sewer mains and electricity networks. Many of these systems are already congested, and can be upgraded only at very high expense – for example tunnelling for roadways. In addition, there are geographical and environmental constraints as developments push further back into the hinterland of existing cities. Covering land with roads and other impervious surfaces increases floodwater runoff, and is often at the expense of high quality horticultural land. Air pollution becomes more severe as developments move away from the coastal plains with their cleansing breeze/sea breeze cycle.

One possible response is to make more provision for higher urban density, but this too has its limits. There may be some saving on transport infrastructure, but there is still a demand for water, sewerage, electricity and land-intensive services such as shops and schools.

Over the last twenty years Australia has abandoned regional development policies, and in any case the regional policies of the past were largely ineffective and tokenistic. Some were spread too thinly. Some "growth centres", such as Bathurst/Orange, were left stranded without transport links. Many "regional policies" were means of subsidising industries, such as clothing, with poor growth prospects. We may now be seeing some of the costs of poor and neglected regional and settlement policies.

The need for regional policies

Relief of pressure on Australian cities will require a set of related policies, mainly under the control of state and local governments. They relate to provision of public transport, roads, access to high bandwith telecommunications, 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.

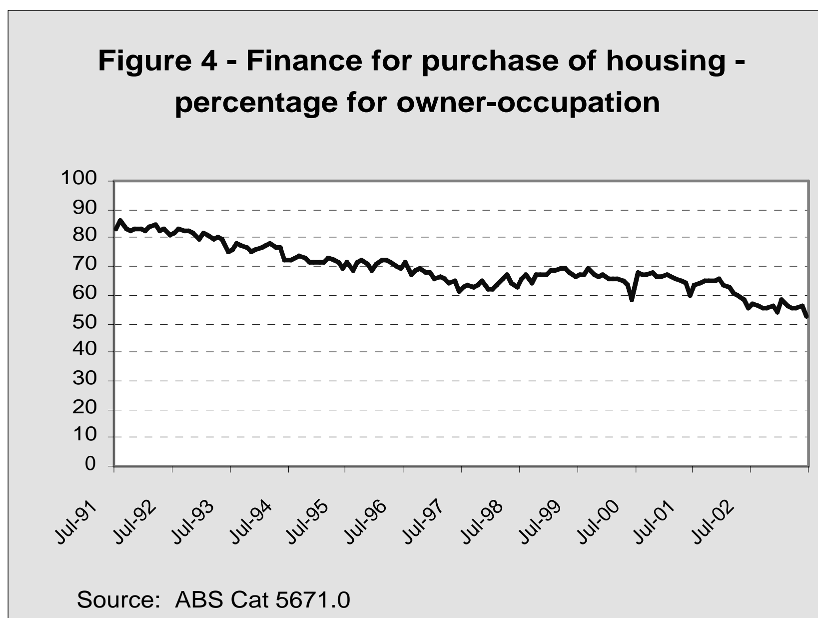
When it comes to development outside state capitals, we are still no further advanced than we were twenty years ago. Admittedly, the last ten years have seen some convergence in the growth rates of the eight state capitals and the rest of Australia, but this is still haphazard and unplanned. Much of what is statistically classified as outside the state capitals is reasonably contiguous with the capitals (Gold Coast, Wyong, Victor Harbour 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 and South Australia's "Iron Triangle" – are suffering low growth or even population decline.

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. Some of the most severe government expenditure cuts over the last twenty years have been in transport infrastructure. Reports, such as the infrastructure "report cards" prepared by the Institution of Engineers, point to severe deficits in transport infrastructure – both road and rail. An ill-informed reluctance by governments to borrow for productive investment, together with a misplaced faith in the private sector's capacity to provide public goods, have contributed to these deficits.

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.



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

Recommendation: That state and local governments re-establish coordinated regional policies, with a view to directing future population growth away from existing urban centres.

3. Demand factors

The growth in housing as an investment in Australia has been spectacular. In 1991, more than 80 percent of housing finance was for owner-occupied housing; now it is just over 50 percent.

There is a risk that when a significant proportion of the housing stock is in the hand of investors, price volatility will increase, as houses come to be a traded financial instrument. Rising house prices cause problems for first buyers; falling house prices carry a risk of negative equity for established owners.

We suggest there have been seven interrelated driving forces contributing to this development:

(1) Widening disparities in income, which, over time have led to disparities in monetary wealth, providing many people with a surplus of investable funds.

(2) Because of longer life expectancies, inheritances coming to people at an age when they are more likely to channel the funds to investment rather than to consumption.

(3) A collapse in equity markets which has caused investors to switch in funding to the “safe” haven of housing.

(4) Financial innovations, including deposit bonds and split-purpose loans which allow borrowers to invest in housing with very little equity and with very little appreciation of the risks involved.

(5) The emergence of new manufacturers and distributors of housing finance products facilitating wider access to these new products and finance in general.

(6) Low nominal interest rates.

(7) Highly privileged tax treatment of leveraged investments and of investments with capital gains.

Clearly the first development is beyond the scope of this inquiry, it is a root cause of many problems in access to supply-constrained or positional goods, such as health care, education and housing. Until Australia develops policies which distribute the proceeds of growth more equitably, these problems will persist.

The second is a result of demographic factors. It has its own positive feedback as highly-priced housing is passed from generation to generation. Capital gains tax exemption for owner-occupied housing, and the absence of death duties, have contributed to this dynamic.

The others, however, to the extent that they are amenable to changes in public policy, are relevant to this inquiry.

We contend that any intervention in the market which stimulates the supply of funding, such as extension of first home owners' grants, are likely to be dissipated in house price inflation. Before any such initiatives are contemplated, it is important to stem the flow of speculative funds into housing. Just as commodity price inflation is regulated by tightening money supply, so too should asset price inflation be similarly treated.

The collapse of equity markets

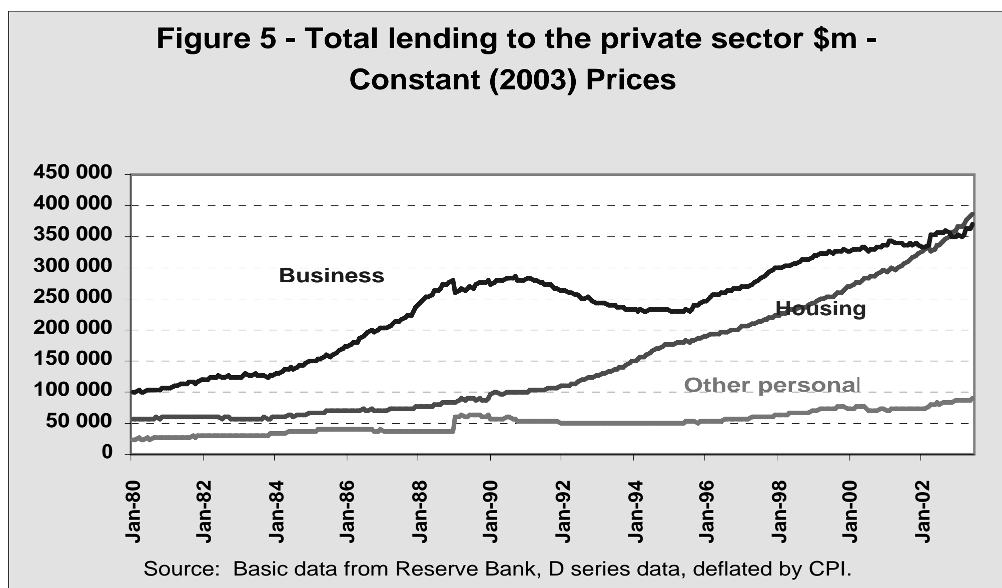
Property has been the highest yielding investment over the last two years, as indicated in Table 5 and in many other available data sources.

Table 5 – Percentage returns on assets

			Average 1985-2001	
	Nominal 2001	**Nominal 2002**	**Nominal**	**Real**
Australian equities	10.4	-8.8	14.0	9.5
Listed property securities	14.6	11.8	12.3	7.8
Direct property investment	9.0	7.9	9.0	4.6
Fixed interest	5.5	8.8	11.6	7.1
Cash (bank bill)	5.2	4.8	9.8	5.4
Govt bond 10 year	6.0	5.0	9.6	5.2

Source: Base data from JB Were Oct 2002, Aug 2003, Govt bond and CPI for conversion to real returns from ABS

Many small investors have been disillusioned by equity investments. Contrary to popular mythology, direct share ownership in Australia is falling. In 2000, following a number of privatizations and de-mutualizations 5.7 million Australians were direct share owners; by 2002 that figure had fallen by 0.3 million, with the strongest falls among younger and



middle-aged investors. Some popular demutualizations, such as Telstra and AMP, have been particularly disappointing for small investors.

Of course one can say it is irrational for investors to abandon the stock market on the basis of one or two years of experience. But it has happened, and investors have looked to the property market, often lured by aggressive marketing.

Supporting this development is a myth that property prices are secure. That is plainly wrong. Even without looking overseas there are Australian precedents, particularly in country towns.

Apart from consumer and investor education, which, at best, has long term effects, there is little that can be achieved from immediate policy initiatives. We can perhaps expect the markets to correct to an extent, but there are still significant distortions which favour housing investment, covered in the next three sections.

Financial innovations

Older Australians recall borrowing being demand-driven; borrowers would have to establish their intentions and capacity to repay before being given access to a loan. Now the market is very much supply driven, with aggressive selling by property developers, mortgage brokers and other agents. Housing lending, in fact, has now outstripped business lending. (See Figure 5)

It is now possible to use instruments such as deposit bonds to borrow with effectively zero equity. Banks have become more lax in lending, in part because they are shifting their default risk to insurance firms.

In no other financial market is it so easy for investors to become committed with so much risk and so little understanding of the risks involved. Although the sums involved are huge in relation to people's wealth and income, there is no requirement for potential investors to be notified of the risks involved, particularly in highly geared investments. Only blatant deception is covered by present legislation.

> *Recommendation: That vendors or financiers of investment housing be required to appraise investors of the market risks involved in housing investment – modelling sensitivities such as rental yields and price movements.*

We have been able to develop a spreadsheet-based calculator which models the sensitivities involved in housing investment. (See below.) It should be an easy task for the finance and real estate sectors to provide similar tools for potential investors.

New lenders and intermediaries

Given their prominent role in driving aggressive lending practices, the practices of mortgage brokers warrant closer scrutiny. In a March 2003 report to ASIC, the Consumer Credit Legal Centre of NSW identified a range of problems with the practices of mortgage brokers, including:

> 2(d) maximising the amount borrowed in circumstances where this is not in the consumers' interest; and
>
> (e) arranging finance for borrowers, particularly pensioners, which they are unable to afford.[2]

A recent report by the Market Intelligence Strategy Centre estimates that brokers account for up to 25 percent of home loans[3], with APRA reporting in January 2003 that brokers accounted for 23% ($76 billion) of home loans with banks, credit unions and building societies, and $86.6 billion of credit with these institutions in total.[4] As the intermediaries for non-ADI (Authorised Deposit-Taking Institution) lenders, mortgage brokers and aggregators (who similarly arrange housing finance) were instrumental in driving competition in the housing finance market, challenging the established market share of the large banks. For recommending particular products, mortgage brokers are paid a commission, typically a percentage of the amount arranged.

It is these commissions, now offered by banks as well as non-ADI lenders which pose the risks identified by the CCLC. Responses to the CCLC survey of brokers indicated that 97% of respondents received commissions or financial benefits from credit providers. With scant regulation of remuneration of brokers, individual brokers generally set their own level of commission. The survey found that the average initial commission paid by lenders was approximately 0.5% to 0.7% of the amount borrowed, with one instance of an upfront commission of 4% of the amount borrowed being paid.

In addition to upfront or initial commissions, lenders also pay trail, or ongoing commissions of an average of 0.3% of the outstanding balance of the loan, generally payable on a monthly basis, and bonuses are also paid by some lenders where business placed with that lender over a specified period of time exceeds set targets.

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[2] CCLC NSW Inc. *A report to ASIC on the finance and mortgage broker industry*, March 2003, p.8.

[3] Market Intelligence Strategy Centre *Mortgage Broker Data Pooling Report*, March 2002: http://www.marketintelligence.com.au/asp/AnnouncementDynamic.asp

[4] Chanthivong A et al. *Report on Broker-Originated Lending: Results of a survey of Authorised Deposit-Taking Institutions undertaken by the Australian Prudential Regulation Authority*, APRA, January 2003.

Moreover, as noted by CCLC in its report, APRA's January 2003 ADI survey found average commissions below these levels, suggesting that non-ADI lenders are paying commissions above industry averages. In APRA's view, the reliance on commission remuneration introduced an incentive for brokers to "generate loan volume without appropriate regard for risk".

These remuneration structures provide clear incentives for maximizing the amount borrowed, pumping finance into the housing market and contributing to asset price inflation, with clear implications for housing affordability. Of even more concern is the risk to borrowers and lenders posed by unsustainable finance arrangements leading to overcommitment and possible future default.

> *Recommendation: That the Commission investigate the various options for capping or otherwise regulating commissions and other incentives aimed at generating high finance volumes.*

Vendor and non-conforming finance

The emergence of non-ADI lenders has driven competition in the housing finance market, with benefits to consumers largely in the form of lower interest rates and product innovation. It has also facilitated wider access to housing finance, and while this has promoted home ownership among previously-excluded would-be borrowers, there is evidence that some of the practices now emerging in the non-ADI and non-conforming sector in particular are contributing to increased borrower vulnerability to overcommitment.

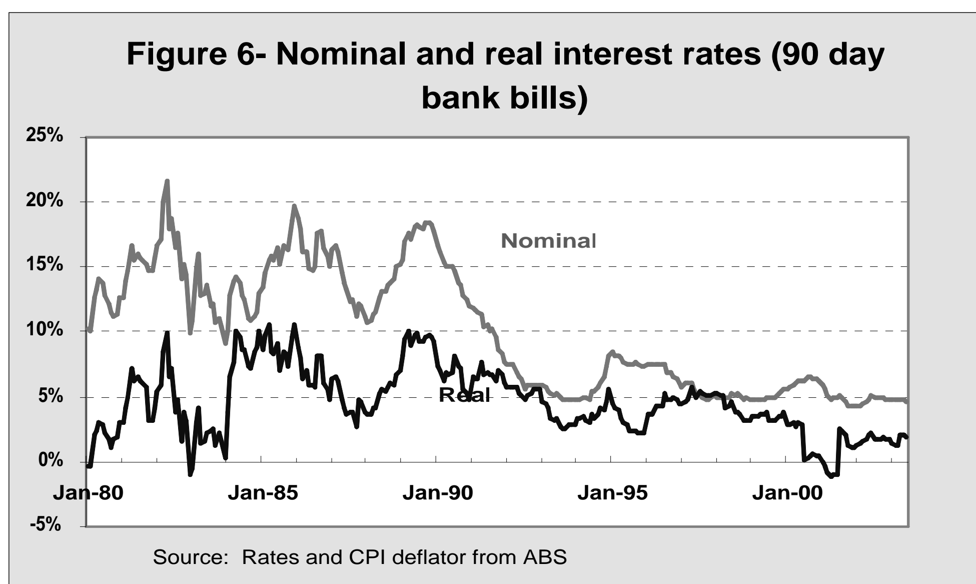
The RBA has detailed this trend in a recent publication *Recent Developments in Low-deposit Loans* (RBA Bulletin, October 2003), in which it identifies vendor finance as a potential source of concern. Vendor financiers typically purchase property from a mainstream lender and then re-sell the property to the end borrower through an instalment sales contract, retaining title to the property until full repayment of the loan. While these arrangements have facilitated home purchasing among otherwise constrained borrowers (due to lack of savings history, lack of an employment record or a poor credit rating), they confer greater risk onto the borrower and can involve substantial additional costs.

These loans generally come with a higher interest rate set at an average of 2-2.5% higher than standard mortgage rates, and the loading of additional debt on top of the purchase price (ensuring a 'capital gain' for the vendor financier). They also have a much higher level of defaults – estimated at 10 percent as opposed to a mainstream rate of 1 percent. These products therefore facilitate entry to the housing market, but at great cost and risk to the borrower.

> *Recommendation: That the development of 'innovative' finance arrangements such as vendor finance not be relied upon as a market response to the exclusion of certain would-be borrowers from the housing market. The Commission should also investigate the options for regulating the assessment of risk and capacity to repay undertaken in approving such finance and how this risk is explained to applicants.*

Low nominal interest rates

Rationally, any borrowing should be determined by consideration of real interest rates – that is, the interest rate after inflation.



But borrowing for housing is often determined by the much cruder notion of repayment affordability – an estimate of the cost of servicing a loan in comparison with earnings – with a figure of 25 percent being a typical benchmark.

In past times of high inflation, nominal interest rates were high, which meant initial affordability was constrained. A $100 000 loan at a nominal interest rate of 15.0 percent imposed an initial annual repayment of $15 000 (plus a small amount of capital). That is 25 percent of a household income of $60 000. If the nominal rate is 7.5 percent, by the same criterion, a loan of $200 000 becomes "affordable" in a household with $60 000 income.

The catch is that in the former case inflation, provided it flows through to incomes as it did over most of the seventies and eighties, rapidly erodes the real burden of loan repayments. When inflation is low, however, the burden erodes much more slowly.

The situation is not helped by politicians claiming that Australia now has historically low interest rates. Nominal interest rates are low, but real interest rates, while low, are not far below their long term average, and investors should be aware that they many previous excursions into low levels have been short-lived.

Tax privileges

Australia's taxation system is biased heavily towards rewarding highly-leveraged investments, particularly in housing.

The most well-publicized such privilege is the Ralph "reform", which replaced a rational capital-gains tax régime (one which was neutral to capital gains and other income sources) with one which placed capital gain tax in a highly privileged position – to tax only 50 percent

of nominal capital gains. In a period of low inflation this has given a large incentive to investors seeking (or expecting) opportunities for capital gains.

The other privilege, particularly favouring highly leveraged investments, is that borrowers can claim as a tax deduction all the interest on their borrowings, even though part of what is designated as “interest” is really a capital repayment. If nominal mortgage interest is 7.5 percent, and inflation is 3.0 percent, then that 3.0 percent is really a capital component. This essentially means there is a double capital deduction for housing investment, because there is also a depreciation allowance of 2.5 percent in housing.

This benefit is partially offset, however, by the fact that capital gains tax is not inflation-indexed. In effect there are two partially offsetting distortions in the tax system, but their effects are not easily predicted – in some very low inflationary situations the effective tax can be very low.

We have developed a spreadsheet model, which we will share with the Commission, illustrating these combined effects. A typical scenario we have modelled is:

- housing loan of 90 percent of property value, 7.5 percent interest, 15 year mortgage;
- real house price inflation of 4.0 percent annually (the capital city average in the ten years to June 2003);
- general inflation of 3.0 percent;
- house rented for 20 years, at a real rental yield of 3.0 percent, sold at end of period;
- 60 percent of value of house depreciable at 2.5 percent a year.

When we model this for a $400 000 property, for an investor with a personal tax rate of 48.5 percent, we find the following returns over the 20 year period:

Initial investment	$40 000
Cash surplus before tax	$1 596 000
Tax	$458 000
Cash surplus after tax	$1 098 000
Effective tax rate	29 percent

Such a treatment looks only at raw cash flows over 20 years. It is not discounted into present value terms. When we apply a discount rate of 5.0 percent to bring these cash flows to present values, we find the following:

Initial investment	$40 000
NPV of cash surplus before tax	$462 000
NPV of tax	$173 000
NPV of cash surplus after tax	$288 000
Effective tax rate	38 percent

It should be noted that we have used a conventional mortgage model. If we modify our model to show the effects of interest-only loan, then the tax rate falls to28 percent (30 percent in present value terms.)

One aspect of this model which we find particularly disturbing is that at a personal tax rate of 31.5 percent, the tax rate faced by most middle-income earners, the effective tax rate on our base scenario is only 19 percent (24 percent when discounted at 5.0 percent). This offers a strong inducement for even medium-income earners to enter the rental property market.

The other, unsurprising, aspect we found was that the higher the gearing the lower was the effective tax rate. The present taxation arrangements encourage high-risk investments.

One may dispute the broad assumption in the scenario that housing inflation will continue. If real housing inflation is brought back to zero the effective tax rates, particularly after discounting, rise significantly. But investments are based on expectations, not on informed foresight – or even on learning from history. The assumption in this model, that housing inflation will continue, is probably a fair description of the expectations driving housing investment.

Sensitivities

Some of the possibilities are shown below – most realistic ones indicate rather dismal possibilities for investors. The discounted outcomes are particularly dismal, indicating the opportunity lost from putting money into housing rather than other investments. Surprisingly, perhaps, is the effect of a rise in interest rates; it would not be significant. But this model does not factor in the effect of the psychological effect of such a move, or the impact on the wealth and cash flow of those who are heavily committed.

Table 6 – Some scenarios facing the optimistic housing investor

Scenario	Cash surplus after tax $'000	
	Not discounted	Discounted
(1) Base case	1 098	288
(2) Real housing inflation falls to zero	325	-20
(3) Real house inflation falls to -3 percent (i.e. nominally stable)	17	-145
(4) Rental yields fall to 2 percent	927	188
(5) Combination of (2) and (4)	214	-89
(6) Combination of (3) and (4)	-64	-198
(7) General inflation falls to zero	466	37
(8) Both general and real house price inflation fall to zero	24	-142
(9) A 0.5 percent rise in mortgage interest	1 088	282

Negative discounted returns represent an opportunity loss from investing in housing, rather than secure investments with a five percent nominal return.

The effective tax rates on housing investments are low; that has almost certainly helped channel funds into speculative housing investment. That leads to the question of how severe a disruption would be imposed by a sudden reversal of the ill-conceived Ralph "reforms" and a genuine reform of the tax system to allow deductibility on only the real component of interest. Restoration of a tax system more neutral between different forms of income may help channel funds away from housing speculation and dampen some of the swings of fortune facing housing investors.

Table 6 shows the distribution of household wealth as at mid 2002, indicating that even the highest wealth groups do not have a high proportion of their wealth tied up in rental property. On average, the impact on investors of a fall in housing values may not be as severe as some commentators are suggesting, particularly at a time when the stockmarket (still the preferred vehicle for higher wealth investors) is rising.

Table 7 – Estimated household wealth by wealth quintile, June 2002

$'000

Quintile	Home	Deposits	Shares	Rental property	Super-annuation	Wealth
1	1	1	0	0	15	17
2	38	4	2	3	46	93
3	121	8	4	11	52	196
4	203	15	11	17	76	322
5	415	58	152	58	89	772

Percentage of non-home wealth

Quintile	Deposits	Shares	Rental property	Super-annuation	Wealth
1	6	0	0	94	100
2	7	4	5	84	100
3	11	5	15	69	100
4	13	9	14	64	100
5	16	43	16	25	100

Source: Financial Planning Association/Natsem "Levels, patterns and trends of Australian household saving" 2002.

We recommend, therefore, reforms to the taxation system to bring neutrality between capital gains and other forms of income (essentially a reversion to the pre-2000 changes), and to disallow deductibility of the inflation component of interest on borrowings.

Further, we would recommend that any net losses resulting from interest payments being greater than net rental (or returns from other investments) not be permitted to be deducted against non-investment income. Rather, they should be held over until investment income is

positive. This would remove the attraction of so-called "negative gearing" as a tax deduction, thus preserving public revenue, encouraging investors to consider longer-term returns, and discouraging the use of interest-only loans.

By the same token, lenders should not be taxed on the inflation component of interest earned, a reform which may make fixed interest securities more attractive for risk-averse lenders – as an attractive alternative to housing. Well-secured loans, unlike housing, are at least guaranteed to hold nominal value. And such a move would help those who are saving for a housing deposit, because they would not be taxed on the inflation component of interest.

But we accept that there are some heavily exposed investors who have entered the market late and have become over-extended. We therefore suggest any tax reforms be prospective rather than retrospective.

> *Recommendation: That the Commission recommend reforms to restore and extend tax neutrality for investors. Such reforms should be prospective for new investors.*

Public housing

Public housing has suffered from Commonwealth and state cutbacks over the last twenty years. It is now very much a welfare program for those in desperate situations – in contrast to earlier times when public housing was available to a large range of lower income groups. In that former role its benefits were not restricted to public housing purchasers and tenants, for it was able to exercise some downward competitive pressure on the general housing market. UnitingCare Wesley has recently identified the substantial increased risk of homelessness that declining housing affordability now presents to many more Australians.[5]

> *Recommendation: That the Commonwealth and states enter a new and adequately funded public housing agreement.*

[5] UnitingCare Wesley *2003 National Report on Homelessness*, October 2003.