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Dear Commissioners

Submission to the Productivity Commission Inquiry into First Home Ownership

This submission seeks to encourage the Productivity Commission Inquiry to consider and recommend a package of measures that would rebalance the demand, supply and cost of housing for first home and other buyers and lead to more affordable access to housing for first home buyers:

1. An increase in the information available to first home buyers and others.

This should be aimed at reducing search costs, to whittle away at information asymmetries and psychological factors that impede the efficient operation of the housing market. Real estate agents should be brought under the coverage of ASIC so that appropriate standards of behaviour can be enforced. The ABS should be encouraged to publish more on the costs of home ownership and the net real returns on investor housing.

2. *An increase in supply and cuts in "unnecessary" costs added to the cost of construction*.

The effective supply of land for housing needs to be increased, by granting fiscal advantages to councils which meet mandated targets to increase land available for the housing stock, financed by penalties levied on councils that do not meet such mandated targets. Costs added "unnecessarily" to construction and delivery of homes should be minimised by national – rather than state-based – requirements, so that the gap between final transaction price and cost of underlying construction can be minimised. The most important example is stamp duty, but developers will doubtless identify others.

3. Earlier action to limit asset price bubbles and busts.

Most (including, apparently, some senior officials) now admit that Australia is experiencing a housing "bubble". This has arisen essentially because interest rates have been too low and credit conditions too easy, due to judgments about the economy by the Reserve Bank board that have turned out to be wrong. An alteration to Statement on the Conduct of Monetary Policy, which sets out the "rules of engagement" for the Reserve Bank of Australia, is needed, giving more weight in policy decisions to early action to limit asset bubbles.

Prudential regulations over credit providers should also operate more counter-cyclically. A higher capital weighting required on loans towards the peak of an economic cycle, and equivalently lower requirements towards the low point of the cycle, would stabilise economic activity and reduce the propensity for bubble behaviour.

4. Encouragement of innovative financing arrangements that enable home buyers, including first home buyers, to more effectively manage the risks of home purchase.

The shared equity proposition put forward by the Prime Minister's Housing Task Force, which was led by Christopher Joye, is an especially promising innovation, offering diversification benefits to many. Any unintended regulatory or fiscal impediments to such arrangements should be alleviated. In addition, encouragement for more fixed rate borrowing seems very appropriate, if only by the RBA publicly canvassing the possibility of interest rate rises as often as it puts the case for interest rate stability or declines.

5. *A rebalancing of the tax-take, with significant cuts in income tax rates offset by an increase in the GST rate.*

   Implemented on a revenue-neutral basis, an increase in the rate of GST and cuts to marginal income tax rates would increase the incentive to save, invest and earn income, while reducing the incentive to consume. The tax switch would also have the desirable side-effect of reducing the attractiveness of the current negative gearing tax arrangements. In any event, variability in the GST rate would be a useful additional tool of countercyclical macroeconomic management.

Consideration

As the Inquiry's terms of reference make clear, there is a multitude of potential reasons for the apparent unaffordability of homes for first home buyers. My submission focuses only on a few.

First home buyers are a microcosm of the entire market and cannot be separated from it. Their problems are in general a derivative of developments in the market for houses.

We must bear in mind that the increasing unaffordability of housing for first home buyers is to a considerable extent a reflection of national economic success.

This paradox is most clear in the aims and work of the Productivity Commission itself, the body commissioned to inquire into the increasing unaffordability of housing. By raising productivity growth throughout the economy, the price of non-tradeables will have risen relative to tradeables. At the margin, labour, a factor of production in direct competition with capital locally and – through international trade – in competition with labour overseas, is "more tradeable" than Australian homes. This is despite the increase in real wages made possible by increased productivity. *Inter alia*, faster economic growth and an increase in the relative price of non-tradeables would diminish the affordability of housing for first home and other buyers.

In addition, if the incomes of the current generation of first home buyers had lagged the incomes of other more established households, as they well might have, a further disadvantage for first home buyers would result. The Inquiry might like to address whether this might have arisen from either the move from one-income to two-income households, or relative wage adjustments that have favoured "middle aged" earners, or from the "casualisation" or the "entrapment in tertiary education" of the younger echelon of the potential workforce.

Economic success has had other paradoxically adverse effects. Nominal interest rates have declined as inflation has been sustainably reduced, and real interest rates have also edged lower as the risk premium for inflation has diminished. This decline in interest rates has had an important transitional effect in raising prices of assets whose yields have fallen less fast than interest rates.

Nevertheless, there are many improvements that could be made and impediments removed that would assist first home buyers and others.

(i) Information asymmetries

Increasingly, as financial deregulation and financial innovation have worked their magic, homes provided the underpinnings and the collateral for an increasing share of economic activity. The market for homes differs from the markets for other financial assets because there are (i) long supply lags, especially given the inflexibility of the land supply and construction requirements, (ii) imperfect information, as the product is not homogeneous and the search costs are extraordinarily high both in money and time, and (iii) imperfect and incomplete financial markets, with no derivative instruments enabling first home buyers or others to hedge the risk of what is for most the largest financial commitment of their life. This makes the housing market especially prone to asset price bubbles and over-borrowing and over-lending[1]. Indeed, it is in the housing market that the information asymmetries that bedevil finance are at their most virulent and disadvantageous for consumers.

The Australian experience since the 1830s has borne this out, with several periods featuring major house price booms. It goes without saying that most of these price-boom episodes have ended unhappily for those overexposed at the peak. Nevertheless, as the relative price of housing rises, first home buyers experience the greatest sense of unaffordability, as their savings for their deposit on their dream home are held as "cash in the bank" rather than as "bricks, mortar and land".

The attention given to improving standards of governance and behaviour amongst corporates and funds managers and brokers in recent years could very appropriately be also directed to those in the sales side of the housing industry. Real estate agents should be brought under the coverage of ASIC so that appropriate standards of behaviour can be enforced.

With information as important as finance, the Australian Bureau of Statisitics should be encouraged to publish more on the costs of home ownership and the net real returns on investor housing, to dispel several illusions that "sex-up" the apparent returns on home ownership or investment in housing.

(ii) Increased supply

Actions to make supply more flexible and responsive to demand would improve the operation of the market, reducing the prospect that demand might run well ahead of supply for sustained periods.

I endorse as a pragmatic, if rather bold, solution the idea of mandating increases in effective land supply put by Christopher Joye and others in their paper for the Menzies Research Centre[2]. Determining those targets should best be "science-based" – i.e., based on proximity to employment and on land area available for growth.

The entire industry complains of lengthy delays and somewhat arbitrary costs imposed on land development that also seem unnecessary.

To the extent that national – rather than state-based – regulation and requirements can be applied to construction standards, so much the better. This might help minimise the gap between final acquisition price and cost of underlying construction.

(iii) Monetary policy

Much of the unaffordability problem comes from the Reserve Bank of Australia's conduct of its monetary policy, which has been too stimulative for too long. If we use the RBA's own "Fisherian" criteria for the normal level of interest rates, the cash rate setting has been "below normal" for most of the last five years during which the house price mania has raged. The bank now appears to be reluctant to use monetary policy for fear of destabilising an unfortunate and very partial dynamic equilibrium in which markets and financial stability depend on house prices and growth of credit continuing to rise faster than nominal incomes.

More active monetary policy, limiting asset price bubbles by keeping the growth of credit more in line with nominal incomes, is very desirable. Early actions to lean more vigorously against emerging bubbles are desirable, even if, later, these actions have to be reversed when they have done their job. More frequent pre-emptive moves in the nominal cash rate and a potentially greater range of moves through the economic cycle (though not necessarily any increase in the average cash rate) would

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[1] IMF Working Paper WP/02/20. Lending Booms, Real Estate Bubbles and the Asian Crisis. Prepared by Charles Collyns and Abdelhak Senhadji. January 2002. http://www.imf.org/external/pubs/cat/longres.cfm?sk=15560.0

[2] The Menzies Research Centre Ltd. Volume 1. Innovative Approaches to Reducing the Costs of Home Ownership. A Report Commissioned by the Menzies Research Centre for the Prime Minister's Home Ownership Task Force. Christopher Joye, Andrew Caplin, Michael Kuczynski and others. June 2003. http://www.mrcltd.org.au/secure/mrc.pdf

probably prompt more utilisation of fixed rate home loans, and so diminish some of the financial risk run by households.

Accordingly, I recommend the Treasurer be urged to renegotiate with the Reserve Bank of Australia the Statement on the Conduct of Monetary Policy, notwithstanding its recent restatement, to make explicit the need to have regard to limiting asset price bubbles.

Prudential arrangements for the banks, which remain the cornerstone of the financial system, might also be adjusted by APRA. There is a strong case for counter-cyclical regulations, ensuring that the banks are well-protected in event of a market downturn but are eager to lend when levels of activity and demand are low.

(iv) Financial innovations

In the search for solutions, we must be careful not throw out the baby with the bath water. For instance, limiting borrowings artificially below individual or family unit servicing capacity and below what the financial institutions feel is prudent to lend might take some steam out of the housing market, but would not lead to a "better" allocation of resources, as expressed in consumption and investment choices, or help some first home buyers into ownership.

Indeed, first home buyers and others have benefited greatly from the strong delivery of financial innovations unleashed since financial deregulation began in earnest in the 1980s. These have included fixed rate home loans, home equity loans, mortgage securitisation and so-called low-docs home loans that have emerged to cater for the needs of particular classes of home buyers usually excluded from conventional financial arrangements.

Instead we should try to overcome the market failures involved in the present arrangements. This is most effectively achieved by encouraging financiers to come up with new financing tools, rather than by direct government intervention. One of the more attractive recent ideas is the shared equity proposition that has also been put forward by Christopher Joye and others in their work for the Menzies Research Centre[3]. If there are regulatory or other impediments that frustrate the introduction of such shared equity arrangements, they should be abolished if they are not having an effect that is intended.

There would also appear to be a market failure in enticing demand for fixed rate borrowings (see *(iii)*, above). Australian household liabilities remain very exposed to interest rate increases, as exposed as UK households and very much more exposed than most US or European households. This can have serious consequences not only for the individual household servicing its debts in a rising interest environment, but also because it constrains national policy choices. For instance, the lesser use of fixed rate borrowings by UK households, in comparison to their continental European peers, constrains the conduct of UK monetary policy and argues against the UK's adoption of the euro. In Australia's case, monetary policy action has been constrained somewhat through 2003 and households now stand very exposed if interest rates do begin to rise.

(v) Realignment of fiscal incentives

There are several things within the Treasurer's own domain that can be brought to bear to lessen the problems facing first home buyers.

At the least, with the permission of the State premiers, the rate of GST could be increased and the rate of income tax reduced on a revenue-neutral basis. This tax switch would increase at the margin the incentive to save and invest and increase the incentive to earn income, while reducing the incentive to consume. (The direct impact on housing costs is regretted.) It would also have the desirable side effect of reducing the benefit to high tax rate payers of negative gearing.

If this proved politically too difficult, then restricting the tax deductibility of negative gearing to the tax on incomes generated from the same asset class might be considered. This is a second-best solution with several inefficient features, for instance favouring the already wealthy at the expense of the next generation of would-be rentiers.

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[3] *Op cit.*

Quite apart from the argument for a revenue-neutral tax switch in favour of an increased GST rate and reduced rates of income tax, there is a further case for variability in the rate of GST as a tool of countercyclical macroeconomic management. For instance, to the extent that fiscal ease through cuts to the GST rate can reduce dependence on interest rate decreases to stimulate the economy in its more subdued periods, home prices may rise less through the cycle.

Finally, previous interventions to assist first home buyers, such as the Commonwealth government's First Home Owners Grant Scheme, has probably exacerbated the problems facing today's crop of would-be buyers. The grant appears to have led quickly to equivalent rises in the price of new and established housing. The grant would best be wound back, despite the apparent immediate detriment to first home buyers.

Conclusion

The problems identified above are not the only factors that have driven up the prices and financing burden facing first home buyers. However, each factor is important and adds to the overall outcome, which has prompted the commissioning of the Inquiry. Addressing each of the problems with the solutions proposed above would go a considerable way to a coherent change in first home buyer affordability.

I wish the Productivity Commission Inquiry well in its complex task.

Yours sincerely

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