SUBMISSION TO THE PRODUCTIVITY COMMISSION INQUIRY INTO THE AFFORDABILITY OF HOUSING FOR FIRST HOME BUYERS

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EXECUTIVE SUMMARY

- This submission concerns affordability of home ownership, although the need for housing affordability for low income renters is recognised in the submission. Affordability for ownership has become progressively worse over the last twenty years, and it is probably worse than in the last fifty years. For the reasons discussed it will almost certainly get progressively worse in coming years under present policies.

- In analysing the question of home affordability, the distinction needs to be made between housing in the bricks and mortar sense, and the market for urban residential land. The first is like a normal manufactured product, in that its market price reflects cost of production, and if more is spent on it, supply usually increases. Over the years the 'bricks and mortar' element has become steadily more affordable. By contrast, the price of the land element in housing bears no relationship to its 'cost of production'. Increased spending on it raises its price but mostly has no effect on additions to supply. Additions to supply are made by government decisions unrelated to immediate market pressures, and the supply in established areas cannot be increased. The land component of housing now dominates its price, is the element that gives rise to the capital gain in housing, and is the element that needs to be addressed.

- Affordability will worsen partly because of Australia's urban structure. 65% of population, and even more of new jobs, are located in five main urban areas which completely dominate their respective states. Most urban growth occurs therefore as incremental releases of land on the fringes of these dominant cities. However, because of distance from the most attractive parts of the cities and from existing centres, transport routes and employment, these new releases are a poor substitute for the bulk of residential land in the cities. Various factors mean this land is not cheap. Consequently fringe land releases have little or no impact in lowering land values across the cities. Sydney, where land values are highest, is the outstanding case of what a poor substitute new land releases are, the only available areas being 35 km from the city centre and in its least attractive sector.

- Increased housing densities in established areas (urban consolidation) faces political difficulties in implementation, but even then is a highly qualified answer in terms of increasing supply to improve affordability. It often increases the supply of apartments by replacing detached houses and so decreases the supply and worsens the affordability of the latter. To the extent that construction costs are a factor in affordability, high density housing is more expensive than detached housing. Higher densities may give rise to other costs such as for augmented utility services. More land may be needed for retail or roads at the expense of land for housing.

- The reality is that because of these obstacles and higher costs, urban consolidation occurs largely in conditions of high existing-house prices. These high prices force up the price of the land element in higher density replacement housing, so creating another high cost factor. Consolidation tends to slacken off when housing prices ease. These cost factors mean consolidation tends to result in medium to high priced housing. While any costly inefficiencies in the administration of urban consolidation should be addressed, it is doubtful if market-driven urban consolidation can be relied on greatly to improve affordability.

- Affordability will worsen also because house price rises self-generate: rises cause further rises, and so on. This is because, with new home buyers a distinct minority, the overwhelming source of finance to buy houses is the value of existing houses. This is the case with owner-occupiers funding new purchases with the increased value of their present houses, or individual investors (that is, most investors) using the increased value of their houses as security for borrowing. The prospect of capital gains so generated then draws in further investors, and leads lending institutions to be confident about lending higher amounts. With confidence about long term capital gain, investors accept yields which are low compared to other forms of investment.

✂Because urban residential land in established areas has no cost of production, its value is purely based on market perception of what is a reasonable price. Hence previously high values soon become seen as reasonable in the public mind: owners have raised expectations, and buyers and lenders are comforted that capital gains will soon justify the new higher prices. Thus in booms, and over the long term, urban residential land prices self-generate rises, in a cumulative process.

✂The likely outcome for Australian cities is a society where there is increasing level of life long renting, with the long term insecurity and cost compared with home ownership. The vast majority of low and many middle income earners will be in this group. Those on low or middle incomes who enter into home ownership via borrowing will face very high proportions of income to meet repayments over many years, with pressures to have two incomes in households. This will also adversely affect family life, such as in decisions to put off having children.

✂Those who will benefit will be high income earners able to buy in early in the housing market, those who inherit urban residential land from their families, or those who acquired at reasonable price years ago what has become a highly valuable asset through no great effort of their own. There is thus a very strong generational inequity aspect to the urban residential land market. This market is largely the buying and selling of a fixed or diminishing supply of a type of asset, not one of demand generating supply. Economic activity in the value added sense amounts to transaction costs such as a large real estate industry.

✂The other major economic effect is that it funds the living standards of those exiting the market, who on the basis of selling a long held asset bought at reasonable price years ago can enjoy greatly enhanced consumption. Thus young working households tend to support enhanced unearned consumption by the better-off old. The urban residential land market, in allocating the ownership of the only form of wealth that really matters to most households, has thus become a financial process for increasing inequality on a large scale, often unrelated to effort. What has developed is ’rent-seeking’ of unequalled magnitude.

✂There is no evidence of feedback mechanisms that will lessen the workings of this market. Thus Sydney where values are highest has experienced no slackening of growth due to high housing values. High land values in a city have no discernible adverse effects on job creation there. There is no evidence of a market revolt of any kind. Those forming new households have no option but pay prevailing prices.

✂To achieve a much more optimal situation on housing prices, both economic and social, requires policies that will address both the demand and the supply sides. Policies will prove ineffective unless both sides are dealt with. The key issue is the market for the land component of housing.

✂A fundamental concept in this issue is that the housing market now serves two types of demand. On the one hand, households bid for housing, through renting or owning, to enjoy a housing service. Some investors may also bid for housing primarily with the earnings from housing in mind. On the other hand, many investors bid for housing not primarily with housing provision in mind, but basically for the capital gain to be made. Some home owners may also bid for housing partly for capital gain. It is this combined demand that has driven housing prices well beyond what they should be, based on a reasonable return as rented or owned housing. Would-be home owners are forced to bid for capital gains as well as for housing.

✂This can be shown by the fact that using standard criteria for what households should pay for housing as a proportion of income, such as one quarter to one third of gross average earnings, median rents are at an appropriate level, and are certainly not low, for houses or apartments, in any larger Australian city. These rent levels reflect the utility that households get from their housing. Purchase prices are far above the level this reasonable return on housing would support, reflected in low rental yields to investors, because demand is far greater than simply that from those seeking a housing service. In other words it is the prospect of capital gains that is driving prices far higher than they should be based on housing utility.

✂It is the land component of housing which is the main source of capital gain. Except in unusual cases, such as buildings of architectural merit, the house element does not give rise to capital gain. The capital gain driven market in urban residential land is unique among such capital gain - driven asset markets where supply is limited, because it relates to a 'product' that every household needs, covering a significant part of every household budget.

✂The first measure to revert the housing market to one not overly distorted by capital gains would be to address investment based on negative gearing: that is, the deductibility against other income of interest costs of borrowing to acquire an income producing asset. Negative gearing generally is quite consistent with Australian tax principles, but the unique nature of urban residential land justifies modification of negative gearing in this case. Residential land is unique because of the social and economic costs of its high value, and because under present circumstances typical investments are unlikely to produce assessable income for decades, if ever. The proposal is that negative gearing be allowed for the housing component of an asset being acquired, and for the land component up to a limited value, say $50,000 per housing unit.

✂The effect of this proposal would be that investment in low-income housing, where most of the cost is in the housing element and the land element would often not exceed $50,000 per unit, would be assisted as at present by the tax system. However, investment using negative gearing for higher cost housing, where the land element is invariably a larger part of the price, would be less profitable than now.

✂A second measure relates to Capital Gains Tax (CGT). In 1999 the rate of this tax was (broadly) halved. The Government gave as its main reason the need to increase investment by individuals. However, the urban land market is the one area where, due to almost zero elasticity of supply, greater investment with the aim of capital gain serves no good purpose , but rather brings social and economic costs. The proposal is that the CGT apply to all, rather than half, the capital gain on non-owner-occupied housing, in effect to the land element. Depending on the expected rates of capital gain, this would make investments in housing several percentage points less profitable. For investments where the main earning is from rents rather than capital gain, such as low income housing with a smaller element of land per unit, the effect could be negligible.

✂These two measures would be introduced on all new investments. The total effect would be to make investments in housing, except low income denser housing, much less attractive as an investment proposition, and no longer comparable to alternative forms of investment. If introduced after the present boom subsides, these measures would not lead to a collapse in house prices, but over the long term would undermine growth in prices. The removal largely of investment in housing for capital gain would assist house prices in the long term to settle down to price levels that reflect the utility of houses as a housing service, not as a vehicle mainly for capital gain. Investment in housing for renting would be profitable in itself. Removal of the capital gain investor would lessen owner-occupier interest in housing as a capital gain prospect, and so a cumulative beneficial process would occur. Management and performance of the economy would be improved.

✂On some other tax issues, land tax has limitations as a means to help address affordability problems. Overall, tax deductibility of depreciation of building structures does not seem justified. If the justification of this concession is to provide support for investment in low cost housing, it would be better if it were abolished and the savings from abolition spent more directly on low-cost housing. There seems no case to remove the GST on housing and infrastructure construction costs, as construction costs are not the main problem in affordability. Under present policies, where a highly inelastic supply of urban residential land is the driving factor in high housing prices, stamp duty removal would have little or no effect on affordability.

✂The shared equity proposal needs more examination, but it raises major questions as a solution to affordability of housing. Would financial institutions want to take up such long term risk without earnings until sale? Wouldn't the proposal lead to overall price increases in housing as the net amount spent on housing increases? And wouldn't the proposal mean that a substantial part of financial markets would be dependent on ever increasing house prices, in comparison to now where owner occupiers and small investors mediate between financial markets and house prices?

✂On the supply side, the necessary measures are longer term and more demanding than the two tax changes proposed above, but are essential complements. Continuing the present incremental land releases on the urban fringe, of land which is a poor substitute for most urban residential land in metropolitan areas, will have little effect. What is needed is release on a large scale of land which is a much better substitute for existing land. This means serviced land which has good transport links to employment, or most desirably, ample local employment. In effect it means new growth centres, whether near or far from metropolitan areas. It means new urban strategies for most states in Australia.

✂As part of these new strategies, development of released land needs a comprehensive approach. As well as the servicing and communications aspects, its needs measures to prevent hoarding of released land, a consistent, rational basis for development charges to avoid loading excessive cost onto new development, measures to ensure that the benefit of lower development and other charges are passed to home owners rather than to some other party, and overall a large-scale managed and programmed release process, with both affordability and attractiveness of released land in mind.

✂This approach means that the managing government agency and utility services need the ability to borrow heavily to fund these longer term approaches. Such borrowing is likely to be both financially responsible and economically efficient. Government will inevitably need to spend to make these new growth centres succeed, with a range of incentives. Because of the role of the Commonwealth Government in the finances of government, the need for leadership in this among the competing states, and the Commonwealth Government's overall responsibility for economic and social needs in Australia, the Commonwealth Government needs to provide support and leadership in this new urban strategy.

✂In conclusion, the immediate answer to affordability lies in carefully targetted tax changes, to negative gearing and capital gains, to lessen urban residential land as a field for the unproductive capital gain-driven investment which is distorting house prices. Such targetted changes can protect investment in low-cost housing. The complementary, long term measure is properly funded and managed new urban growth centres, well supported with loan funds for infrastructure, and employment opportunities, which will offer substantial new urban land, managed to achieve affordability. New residential land under such a program will be a good substitute for existing urban residential land, in contrast to more of the present incremental, high-priced fringe land releases.

SCOPE OF SUBMISSION

'Housing affordability' can focus on two broad issues: the affordability of rental housing and the provision of 'social housing' for low income groups; and the affordability of house purchase for other groups. Much work on housing affordability in Australia has focussed on the former, but this Productivity Commission inquiry is focussed primarily on the latter, which this submission addresses. However, the first form of affordability has been borne in mind in writing this submission: measures proposed to assist home ownership have been considered also in terms of how they might assist low-income housing provision. Generally, higher levels of home ownership are likely to assist low income rental markets and the provision of 'social housing', because there will be less competition for rented housing and available 'social housing'.

DISTINCTION BETWEEN THE TWO ELEMENTS OF 'HOUSING'

In analysing housing affordability it is essential to distinguish the two components of 'housing'. One element is the dwelling and all its fittings, or 'housing' proper, the other the land on which it stands, either singly or jointly with other dwellings. These are two very different products.

Housing proper, the bricks and mortar, plumbing and electrical works, and so on, is not unlike other manufactured products, even if it is fixed in location, of very long-term nature, and labour-intensive. It is manufactured on site by a builder, from many other manufactured components. Increased demand for this aspect of housing will call forth increased production in a fairly direct manner. In recent years the cost of housing construction in real terms has not risen, which has meant that Australians on average have been able to afford a rising amount of housing floor space per capita. The cost of house construction is not the problem in 'housing affordability'.

The rapidly rising cost element in housing is that for urban residential land. A main feature of residential land is that it is created by decisions of government on zoning, development consent, and investment in infrastructure, and is necessarily very complex and often slow in its creation. The most important feature however of this land is that given the structure of cities in Australia and present urban policies, newly created residential land is a poor substitute for, and less valuable than, most existing such land. This is mainly because it is furthest from city centres and other employment, is in less attractive areas, and is poorly served by transport links and other facilities. Where land is rezoned for higher density development in inner areas, the same outcome occurs: a much smaller area of (shared) land in an apartment block is a very poor substitute for a larger block of wholly owned land on the same site. Thus supply of additional residential land is complex and often unsatisfactory in relation to demand.

In essence the problem of housing affordability in Australia is the problem of the market in residential land, and needs to be addressed as such.

The distinction between land and housing is well understood in Australia: most rating systems are based on the unimproved value of land, and there is popular understanding of concepts such as the undercapitalising of housing land (too valuable a block for the housing on it).

In other respects however this distinction is ignored, bedeviling discussion of housing affordability and measures to address it. For instance, measures such as higher interest rates, designed to address rising house prices caused by the high price of land, are decried because they will impinge on the level of activity in the housing construction industry. Measures advocated in this submission seek to address the real issue, the market in residential land, while avoiding collateral damage to the housing industry and thus the extent of housing provision.

NATURE OF THE MARKET FOR RESIDENTIAL LAND

Because most employment in Australia is found in the main metropolitan regions, participation in the residential land market, as an owner, buyer or renter, is a necessity for most Australians. For buyers and renters, because of prevailing price levels, this is likely to be a major part of their spending, in fact it may well be by far the biggest 'product' they are obliged to purchase. At the same time, this is a product whose supply is very difficult to expand, where additions to supply are almost certainly a poor substitute for most product on the market already.

In fact, there is little or no relationship between the levels of spending on residential land and increase in supply, because of the delayed and complex nature of that increase. Historically in Australia's cities there seems to have been little evidence of the price of residential land driving the release of new land to add to supply. In other words, the price elasticity of supply of residential land is close to zero for a time span of several years at least. Also, geographical separation means that over much of a metropolitan area increased levels of spending in bidding for residential land has no effect on land releases on the urban fringe.

In these respects, residential land is a unique product. While there are other products where 'investors' bid for ownership and supply is very inelastic, none is the necessity, nor comprises such a large part of ordinary household budgets, as this land. 'Investment' in residential land is therefore a unique form of investment, almost invariably driving up the price of an expensive necessity without adding to supply and thus to the stock of capital. For many types of residential land, such as blocks with houses in established areas,bidders are operating in a zero sum game, with bidding for what has been termed a 'positional' good. Because of the unique nature of this form of investment, and the social and economic costs it can bring about, it warrants different approaches from other forms of investment.

THE CURRENT MARKET FOR RESIDENTIAL LAND IN AUSTRALIA

Currently in Australia the scarcity price of the land component in the average cost of housing is often equal to or greater than the building cost component. The building cost of a free-standing house for a family might vary between $100,000 (modest) and $200,000 (large), and long-standing houses can be valued in this way. There is also the question of the construction costs of the immediate infrastructure for housing , such as local road and utility services, which needs to be considered as part of the cost of production of housing. Costs would vary greatly by standards, definition and location, but going by current new developments, costs on average should certainly not be greater than $50,000 per house. This upper limit figure can be assumed for the infrastructure construction costs of long-standing housing. (This analysis assumes that the costs of arterial roads, trunk utility services and headworks should be funded in the way they have largely been funded in Australian cities to date, by borrowing by agencies financed by rates on all users, rather than by charges on newly released land. The question of developer charges on newly released land is discussed below).

In effect, the difference between $150,000-250,000 and typical prices paid for free-standing houses in Australian cities is the result of bidding for scarce land. Thus the median scarcity price of residential land (the difference between the median price of a house in a city and, say, $200,000) is

Sydney $350,000 (median price $550,000 less $200,000), Melbourne $180,000, Perth $149,000, and Adelaide $58,000. (Source of median prices at August 2003 is www.homepriceguide.com.au).

WORSENING AFFORDABILITY

There is a gradual long-term worsening of housing affordability in Australia. Figures quoted in the report by Joye and Caplin on home ownership, published by the Menzies Research Centre, show different measures in general agreement on the extent of home ownership, and a decline over the last twenty years. In the early eighties home ownership was around the 70% mark. Given the much lower level of ownership until after the second world war, and the very slow rate by which ownership levels change because of the gradual change in total household composition, it seems clear that the ability of households to acquire their own homes must have been at least at the 70% mark for some decades before the early eighties.

According to census figures, the rate of home ownership fell from 69.1% in 1986 to 66.2% in 2001. This fall of about 3% over fifteen years would be achieved by a uniform level across the fifteen year period of about 60% in the percentage of households newly entering the housing market who are able to buy their own home. However, overall the trend seems to be for affordability to become worse, within the general pattern of booms when prices rise quickly and then plateaus for some years. It seems likely that if the average over the fifteen year period was 60%, by 2001 it was well below this, and that the ability to become a home owner in 2001 was therefore probably at its lowest level for perhaps fifty years.

This was prior to the present housing boom when house prices have risen 40% in the last two years, which has made home ownership even more difficult. Even accepting that ownership may become somewhat easier after the current boom ends, several factors suggest that affordability will become progressively more difficult in the future. These factors are:

- The intensification of Australia's current urban structure, with employment becoming ever more concentrated in a few major cities, and no large programs which are alternatives to the essentially incremental release of relatively small areas for urban growth on the fringes of these few dominant cities. These issues are discussed further below.
- The development of new finance products following financial deregulation in recent years, which have added, and will add in the future, to the amount of funds available to buy housing. Greater levels of finance accessed by these new products will inevitably raise prices and will tend to accentuate the differing abilities of households to raise finance for housing. This general phenomenon has been noted in the 2002 annual report of the Council of Financial Regulators (that is, the Reserve Bank , APRA and ASIC) which has attributed the recent rise in house prices to some degree to financial deregulation and new financial products. These will continue to work their way through the economy.
- Progressive casualisation of the workforce, which will undermine the ability of an increasing proportion of the labour force to confidently take out housing loans.
- With many goods becoming increasingly cheap, such as manufactured goods, the increasing proportion of people's income that they are likely to spend on so-called 'positional goods', those which are valued essentially in relation to other goods in their class. The essence of such goods is limited or no additional supply. Urban residential land is the supreme example of such goods. (This aspect is discussed in a thoughtful article on housing affordability by economics writer Ross Gittins of the SMH, in an article of 9-10 August 2003). Clearly with greater bidding for housing on this basis, disparities in ability to buy will increase.

The behaviour of housing prices tends to be that they rise steeply with housing asset price booms. When these booms break, even if the price of some speculative apartments fall, house prices generally do not fall because owners tend to hold off selling at a lower price than they have come to expect for their properties. House prices then tend to plateau in real terms for a number of years, before the next price boom occurs. The overall effect is for a gradual ratchetting up of house prices over the years, with decreasing affordability for many. What will be the economic and social effects of this?

CONSEQUENCES OF RISING PRICES FOR RESIDENTIAL LAND

One consequence will be a growing proportion of households renting rather than owning their housing. Given that a certain proportion of population, perhaps the lowest tenpercentile of the population, will never have the financial resources to own their housing, and that at any one time a bigger proportion of the population than this, for temporary or lifestyle reasons, will want to rent, the figure of 70% ownership that Australia has achieved in recent years must be very close to the maximum attainable. Certainly no comparable country has achieved a higher level.

Home ownership provides enormous personal and thus general benefits to society and the economy. Going through the process of buying a house on mortgage means that for an initial deposit and for weekly payments which have often been little larger than rents, households acquire a highly valuable asset which provides wealth and security, especially in old age. The Henderson inquiry into poverty in the 1970s showed that an age pension as low as one-quarter of average weekly earnings provided modest comfort for the elderly, provided there was home ownership.

Home ownership by way of a mortgage over many years is essentially a means for persuading people to save at a slightly higher rate than they would otherwise do, for great long term benefit. They are willing to do this because of the perceived long term benefits, the emotional attachment they develop towards their homes, and the very illiquid nature of their asset. Home ownership is also very beneficial because people are able to use their spare time in a very satisfying way to improve the monetary value and attractiveness of their dwelling in a way not open to tenants.

Households which are long term renters, by contrast, face much less security of tenure, the prospect of rents which may rise greatly with time, no long term valuable asset, and the inability to use their own time to improve their housing with the certainty of their own benefit. The slightly higher disposable income that may arise from not having a mortgage, and the greater mobility possible with renting, do not really offset the large long term costs of renting versus ultimately owning.

In a situation of worsening affordability, the minority still able to become home owners face having to find a large deposit to enter the market, and then having to pay a very significant proportion of gross income for many years. Currently in Sydney median housing prices suggest that new home buyers need to find a 10% deposit of $55,000, and then on a 7% loan face yearly repayments of $35,000 a year. Yearly payments of this size will in most cases mean that two above average incomes will be needed for many years, and clearly will have profound implications for disposable income on other forms of consumption, and decisions such as whether to have children.

There are empirical studies that support the intuitive conclusion that housing options have major implications for things such as family size, and much reflection in the media of the awful position that young people, even those on apparently high incomes, now face, compared with the family and lifestyle decisions faced by earlier generations when home ownership was much easier. (See for instance the feature article in the SMH of 4 August 2003 on what young people in Sydney face: 'Cost of a first home: big bucks and the best years of your life'.)

A SOCIETY DOMINATED BY HIGH RESIDENTIAL LANDVALUES

High residential land values in Australian cities will therefore increasingly act a mechanism , via high mortgages, or rents that will increase over time, for reducing the relative standard of living of young households, to the benefit of those already owning or investing in residential land. The fortunate will include those who through inheritance come at some stage, probably late in their lives, to receive unearned parcels of residential. A privileged class will arise, based on the ease of residential land ownership in a past era, or inheritance.

The market in residential land is essentially one of the buying and selling of an essential but expensive 'product' fixed in quantity, so far as most areas are concerned. There are transaction costs involved in buying and selling, such as those from a large real estate industry which earns its fees largely as a proportion of sale values rather than in winning a price higher than the easy-to-achieve going market rate. However, for the most part, because it involves just the buying and selling of a fixed quantity of assets, the market does not involve increased production, just wealth transfer.

Currently only 13% of buyers of houses are new home buyers. About 37% of the buying of housing is for investment, not owner-occupation. Consequently about 50% of the market is of those already owning their housing who are buying again for owner-occupation.. However, many of those investing in the housing market are those using their equity in a house already owned. It is therefore clear that the funds from the sale of housing to a considerable extent, perhaps overwhelmingly, are used to finance the purchase of housing. In this way the price levels for housing feed on themselves, an issue which is discussed further below.

For some, however, who are moving to a less expensive house, or housing market, the sale of high priced residential land will be the means for a much higher level of consumption. For instance, many detached houses in inner or middle suburbs of Sydney that were bought decades ago at a price well within reach of an average income earner now sell for $600,000 to $1m, most of which represents the land component. Moving to lower cost housing outside Sydney costing say $300,000 leaves a capital sum of $300,000-700,000. Taken as a lifetime annuity by a couple aged, say, 60, these sums would provide a consumption level ranging from comfortable to very generous for the remainder of their lives.

Thus the market for residential land in Sydney currently is a mechanism which does not increase supply but rather imposes a heavy financial burden on new households (younger people who must work and may want to also raise families), either for many years, or for a lifetime if forced to rent for the rest of their lives. This market primarily benefits households from an earlier generation who simply acquired housing at the reasonable going rate at the time. Figures for other Australian cities are less dramatic than those for Sydney but are still significant. For instance the median house price in Melbourne is now $385,000, meaning two average full-time incomes are not enough to finance such a mortgage assuming 25% of gross income is spent on housing.

What has developed therefore is 'rent-seeking' on a colossal scale, with no apparent easy solution. This rent-seeking benefits those who already hold residential land, at the expense of those seeking to own. The residential land market thus acts as a vast mechanism for increasing inequality unrelated to need, and usually unrelated to effort, and based strongly on generational circumstances.

SOME HISTORICAL ASPECTS OF HOME OWNERSHIP

Australia's level of home ownership until recently of about 70% was high by world standards and as noted is probably at about the maximum level attainable. This level was an outcome of the decades following the second world war. Prior to that most Australian households rented rather than owned. The increase in ownership after 1945 had a number of causes, such as the increased standard of living, the availability of the mortgage financing mechanism, the widespread provision of ex-service housing loans, the acceptance of small and simple dwellings by today's standards, and the acceptance that utility services such as guttering and sewerage would catch up with new housing areas in time.

However, home ownership was based crucially on (by today's standards) very cheap residential blocks in new suburban areas. In this respect the post-war development of Australian cities was very different from the present, as follows.

- During this period the population of Australia was much smaller than now, while employment and hence population growth was more widely dispersed among town and cities than now. Australia's population in 1960 was about 10m or half its current level. The population of the largest city Sydney was about 2m also about half its present level. There was a much wider distribution of population growth based on regional industries and agriculture than now, so that the demand for land for housing was more widely dispersed than the present concentrated pattern, where more than 70% of the population is located in five main urban regions of Brisbane-Gold Coast, Newcastle-Sydney-Wollongong, Melbourne-Geelong, Adelaide and Perth. Hence the demand for urban land was far more dispersed and there was a much greater area relative to the population size that could be provided with land accessible to city centres.
- As well as there being more land relatively near existing urban centres, this land was often near public transport lines, especially rail lines, which radiated from the city centres where employment was usually located and made available a great deal of land which could be turned into convenient suburban areas. For instance, the East Hills railway line in south western Sydney was built in the depression as a make-work project, through the undeveloped southern Bankstown area. A large area here was able to be turned into transport-serviced suburban blocks very easily after the second world war.

Thus particular factors relating to urban structure and population size greatly facilitated the supply of convenient, low cost residential land, so assisting home ownership. These factors no longer operate. We now turn to key features of Australia's current urban structure which influence housing affordability.

AUSTRALIA'S URBAN STRUCTURE

As noted, about 70% of Australia's population live in five main metropolitan areas. This pattern may seem relatively dispersed compared with other countries which developed since the industrial revolution such as New Zealand or Argentina where a third of the country's population live in the main city. However, the key feature is the dominance of these five main regions in their respective states. Typically the remaining urban settlements in the states have at most one-twentieth of one-fortieth the population of the main urban area. They are few in number, and often very distant.

Given that the non-metropolitan areas have mostly higher than average welfare dependency and unemployment rates, it can be seen that employment growth is overwhelmingly concentrated in a few metropolitan areas which comprise single areas in terms of urban growth and the residential land market. It can be seen that it is these areas were most employment opportunities are is where younger people will be drawn, forming new households and new entrants to the housing market.

There is simply no network of towns and cities of varying sizes within easy transport distance of each other which is typical of many industrialised countries, such as those of Europe or the US. Such a network provides great advantages in terms of accommodating urban growth. It provides immediate competition between urban areas to bid for new growth. If we see urban growth as being mainly growth on the fringes of existing towns and cities, a network of separate urban areas provides a very long total 'frontier' to absorb a given amount of growth. Such a network provides ample opportunities to take advantage of existing infrastructure and nearness to town or city centres.

By contrast, if urban development is one continuous area, all new development pressures will occur on only one development 'frontier'. The pressures on this one frontier will be all the greater if parts of the frontier are closed for topographic or other reasons. Sydney is the outstanding example of this, where expansion is only possible now to the west of the main urban area. The upshot is that a very different approach is needed from one of incremental land releases. A much more strategic approach, with proper funding of infrastructure, is needed, to accommodate the pressures that build up, and to avoid the temptation offered to landholders, government bodies and utilities to take advantage of these pressures.

There is no evidence of negative feedback mechanisms in Australia's urban structure, arising from high land values, that will lessen the intensity of the residential land market. Thus Sydney where values are highest has experienced no slackening of growth due to high housing values. High residential land values in a city have no discernible adverse effects on job generation there, essentially because the costs to individuals of job location decisions are generally not part of the costs borne by firms but are external to them. There is no evidence of significant market revolt. Those forming new households have no option but to pay prevailing prices.

THE SELF PERPETUATING NATURE OF RESIDENTIAL LAND PRICE RISES

An important factor in residential land prices is the fact that metropolitan housing markets in Australia are insular from one another, and tend to be self-supporting: existing high prices generate even higher prices.

Markets are insular because the major housing markets based around each state capital city are hundreds of kilometres from each other, and most buyers are from the same metropolitan market. Generally people may change jobs and houses, but these changes mostly occur in the same metropolitan area. Thus houses bought for owner-occupation are very likely to be for people from the same metropolitan area. Even with housing bought as an investment, a major part of these investors are 'mum and dad' investors, who buy only one property. With these, the transaction and supervision costs of acquiring and managing one property hundreds of kilometres away are likely to strengthen the insular nature of housing markets.

Reinforced by this insularity, housing prices tend to self perpetuating, or more likely, self promoting. The reason is that the overwhelming source of funding for house purchasing is already existing equity in housing. This is shown by the fact that the proportion of first-home buyers is very much a minority ranging from a high of 25% in the late 1990s to a current proportion of only 13%. The largest class of buyer is owner-occupiers who already own their house. Given that overall little is owed on average by those already owning a house, and that most household wealth in Australia is in the family home, clearly the predominant source of finance for this class of buyer is the equity in a home which they are selling. Higher values for the existing home will therefore fund higher bidding for the next home.

Even with the second largest sector, the investor sector, (currently providing about 37% of finance for housing purchases) rising house price levels will underpin further rises, because small investor, the predominant component, often use the equity in their own housing to help finance investment purchases, so that their rising equity supports their own higher bidding for properties.

House prices in a metropolitan market are also self-promoting in another way, that of perceptions about what is a reasonable price. As there are no cost-of-production fundamentals to give some realistic context to what urban land is worth (unlike most other products), and as location is so related to lifestyles and social values, what is a reasonable 'value' of a piece of urban land is solely what the market says is reasonable. In this way rising values which seem laughable or outrageous one year look reasonable next year, and market values self-promote. The 'irrational' side to housing values can also be seen in the way prices for detached dwellings after the bursting of a real estate bubble do not fall, in nominal money terms at least, but plateau for some years. Owners cannot face the fact that the price of their house has fallen from an earlier paper value, and withdraw their houses from the market until the nominal value has risen, even though it might be rational to sell well above their original real cost, and buy in a falling market.

The long term pattern is therefore for prices to rise rapidly in a boom in a self-generating way, as seen in the rise in house prices of 40% in the last two years, but then not to fall for most housing types, but to plateau for some years. The overall effect is a ratchetting up, with long term real price increase and falling affordability.

THE DISTORTION OF HOUSE PRICES BY CAPITAL GAIN SPECULATION

A huge distortion has entered the housing market in Australian cities. Those seeking to buy a house for the utility it offers as a housing service are obliged to bid far above this utility price, in order to gain the long-term benefits of home ownership and to avoid the long term costs of being renters for the rest of their lives. They are forced to enter a market increasingly dominated by capital gain, when what they want is a housing service in a particular location, and do not wish to be part of a capital gain bidding operation. This can be illustrated by looking at rent levels versus house prices, and yields on housing as an investment.

A widely accepted rule of thumb is that households should pay 25% of their gross income on housing. At average weekly earnings of $40,000, with one income in a household, this means $10,000 a year on rent, or about $200 a week. Interestingly, this figure is not far off the current (June 2003) figure for the median rent of a unit (apartment) in Melbourne, Perth and Adelaide ($11,600, $10,700 and $8,600 respectively). If we expand this possibly conservative standard of housing spending, to assume one and a half average weekly earnings in a household, with the same limit of 25% of gross income, we find that the figure of about $15,000 a year, or about $300 a week, is not far off the cost of renting the median unit in Sydney ($16,000), or renting the median house in Sydney, Melbourne, Perth and Adelaide ($16,500, $17,500, $15,000 and $12,700 respectively).

These standard proportions of average earnings, and the not dissimilar actual rents being paid, reflect the utility to Australian consumers of housing in these cities, in the context of the Australian economy, and thus the real market value of that housing as a service. If we turn however to where the housing consumer is a buyer rather than a renter, where the housing occupier enjoys the same housing service but also buys the property by paying off each year a very small part of the property's value over 30 years, the cost of buying should not be markedly greater. After all, the occupation of the asset is the major cost to the owner, whether that owner is a landlord or the occupier. However, the costs of acquisition are far greater than renting, out of all proportion. Under current values in Sydney, buying the median house costs well over twice the cost of renting, assuming a mortgage rate of 7%. In other cities the cost of buying is mostly well over 50% higher than renting.

In other words, the price of houses and units when acquired bears no relationship to their value as a housing service in a particular location. Buyers of houses are being forced to buy two different benefits, the housing benefit and a capital gain many years into the future which they may not even want. It is the prospect of capital gain by investors which is driving much of the demand for housing, not the desire for a reasonable return on the provision of a housing service. Measures are needed to return the housing market to a situation where prices reflect the service on offer, and not an additional benefit which housing consumers are forced to buy, or which forces them out of the market as owners.

A useful alternative way of illustrating the distorting effect of much non-owner 'investment' in housing is to look at current yields of such investment, that is, net rental income against the price of the asset. There are published gross income yields based on gross rent levels. Net rent from properties vary with every property and net rent can often be only half of gross rent. Assuming however that net rent comes to 60% of gross, the current yields on housing properties are extremely low. Net yields on houses in Sydney are currently 1.8%. In other cities they range between 2.6 and 3.1%. Net yields on units are slightly higher ranging between 2.4 and 3.5%. All these yields are less than the interest rates from term deposits in a bank. Clearly, investment in housing is not being undertaken for what can be earned in providing a housing service, but for different financial reasons. Unfortunately the pursuit of these other financial objectives is driving up prices for those who want primarily to buy housing as housing.

In summary, those bidding to buy residential land comprises two types of demand, those wishing to buy housing to provide a housing service to them in a particular location (primarily would be owner -occupiers) and those who see residential land as a field for capital gain, where very low earnings from providing a housing service are no disincentive.

REMOVING THE DISTORTION OF CAPITAL GAIN-DRIVEN INVESTMENT FROM THE RESIDENTIAL LAND MARKET

As discussed above, the market for residential land is driven by those seeking capital gain not those seeking a reasonable return from providing a housing service. Prices for housing need to return to levels that reflect its value for that purpose. Supply-side measures which would reduce capital gain prospects and so discourage such 'investment' are discussed further below, but more immediate measures are available which would achieve this objective and, it is argued, are essential if any set of measures are to be successful. These measures are based on the unique nature of residential land as a field for investment: it is an essential, a large part of people's spending, yet very difficult to expand in supply, where any additions are a poor or no substitute for most existing supply, and where additions to supply have little or no relation to higher levels of bidding for it (where price-elasticity of supply is zero or very close to it). In these respects it differs from all other areas of investment, including those for capital gain.

Unless measures are taken to address this problem, there is every prospect that residential land will become a more and more attractive area for investment for capital gain, and the whole process will become self-reinforcing.

- **NEGATIVE GEARING**

Negative gearing under the Australian tax system is based on two principles: that the costs of acquiring an asset which is going to produce assessable income are deductible (except the capital cost itself of the item), including interest costs of borrowing money to buy the asset; and that losses in one area of income of a taxpayer can be offset against income earned in another area by that taxpayer. In general these are acceptable tax principles which accord with the overall philosophy of the Australian tax system.

Negative gearing is a major incentive to investment in housing in that the cost of borrowing funds, in particular the interest on a loan, is deductible against other income. Broadly the effect can be portrayed as reducing interest costs by half, if the marginal tax rate of the taxpayer is at the highest rate (48.5%). Under the Australian tax system, the cost of interest is not deductible by a home-owner. There have been many calls for it to be abolished in relation to housing so as to lessen the pressure on housing prices and improve affordability. This was done in 1985 but it was reinstated two years later. It is widely believed that the reinstatement was because the reduced investment in housing arising from its abolition was leading to a reduction in the supply of housing for rental, with a consequent pressure for higher rental levels (although this effect has been rejected by the then Secretary of Treasury, Bernie Fraser).

The resolution of these conflicting outcomes is based on the distinction discussed above, between housing, the product where greater spending leads to increased supply, and residential land, where greater spending has no clear effect on supply, leading basically to higher prices. The proposal is that investors would be entitled to negatively gear, that is deduct interest against other income, in relation to the cost of the housing element in their investment, plus a limited value for the land component per housing unit (say $50,000), but would not be able to deduct interest for the land value above that limited value. As demonstrated in the following examples, a limited element of land is necessary to provide an incentive to investment in the housing element of property, especially low-cost housing, and as recognition that some land element is essential in housing provision. Calculation would be based on the widely understood unimproved valuations of land.

Example: an investor buys a house or apartment in an inner-middle suburb, paying $600,000. The property comprises an unimproved land valuation (ULV) of $450,000 and housing proper worth $150,000. With a standard limit for deductibility of land value of $50,000, the investor would only be entitled to deduct interest on $150,000 plus $50,000 or $200,000. Interest on $400,000 would not be deductible.

Example: an investor buys a a unit in a newly built block of low income apartments in a middle suburb, where ten units have been built on land with a ULV of $500,00, and where the construction cost of the units is $120,000 each, with units selling for a total value of $170,000. The investor would be able to deduct all the cost of interest on a loan, because the cost of land per unit is $50,000 (the allowed limit for deductibility for land per unit) and all the cost of construction is deductible.

Example: an investor buys a unit in a higher income apartment block where the selling price is made up of housing element $150,000 and where there are four units on land with a ULV of $1,000,000, total cost per unit $400,000. The investor would be able to deduct interest on $150,000 plus $50,000 or $200,000.

The effect of this change would be that the strong negative gearing incentive would remain for low-cost housing provision, but the higher the cost of housing based on a high land component in the price, the less would be the incentive. This change would be based on the rationale that investment in housing is desirable, but speculation in residential land should not be encouraged via the tax system. This is based in turn on the fact, noted earlier, that Australian residential land is a unique form of 'investment' where greater bidding for it leads not to greater production but to higher prices and worse social outcomes. Also, under present circumstances it seems unlikely that typical investment properties will earn net assessable income and so pay tax, for decades. This means that the rationale for allowing interest deductibility on acquiring assets, that overall or in time these assets will provide tax-assessable income, does not exist.

-CAPITAL GAINS TAX

It is clear as noted that the prospect of capital gains is the dominant financial motive in investment in housing. Until 1999 capital gains were taxed upon receipt by the taxpayer at the marginal tax rate of the taxpayer. That is, at a rate of 48.5% at the top rate. However, under an announcement by the Treasurer later made law, from 30 September 1999 capital gains were to be taxed as to only half their value, meaning a maximum tax take of 24.25%, combined with an end to the indexation for inflation of capital values. This change made investment based heavily on capital gain much more attractive, and must have been a major incentive to increased levels of such investment. Although it is probably impossible to quantify, it must have been a factor in the current housing property boom, in the four years since its introduction.

When capital gains are made from the sale of housing, the capital gain is essentially on the land component of the asset, rather than the housing structure proper. This is because, unless the housing structure is of such a striking character, architecturally say, that it acquires increased capital value in its own right, it is an asset that at best just maintains absolute value if maintained well, given that it can be substituted for by the building of additional (and more modern) housing elsewhere. The land element by contrast is an increasingly scarce commodity, which with city population growth becomes relatively more valuable.

When this change to capital gains tax was introduced, the main reason given by the government was 'to stimulate greater participation by individuals in investment'. On investment as a whole, this may well be a good reason for the change. However, residential land is a unique form of investment where greater levels of investment under present circumstances for the most part bring no economic or social benefits, but may well be destructive.

It is therefore proposed that a distinction be made in capital gains law between investment in housing and all other forms of investment by individuals, and that the rate on housing (that is, the capital gain on residential land) revert to the previous situation prior to 1 October 1999 , with gains taxed fully, not at 50%.

Example: A taxpayer buys a housing investment property on 1 March year 1 for $400,000, the property comprising ULV of $250,000 and a notional housing element of $150,000. He sells it two years later for $450,000. The ULV has increased to $300,000 and notional housing value remains at $150,000. Under present tax law he would pay tax on $50,000 divided by two, or $25,000. Under the proposed change he would pay capital gains tax on the full $50,000, the full increase in the land value.

This change would tend to make investment in residential land relatively less attractive than other forms of investment, compared with the current situation. A higher level of capital gains tax on housing is unlikely to have much impact on investment for low cost housing, such as lower priced dense apartments, because in this form of housing the capital gain element is smaller in terms of the overall financial benefit from the investment, because the overall land element is smaller in the investment as a whole. Within the general area of investment in housing, this capital gains tax change would therefore tend to shift investment from higher cost to lower cost accommodation.

IMPLICATIONS AND IMPLEMENTATION OF THE TWO PROPOSED TAX CHANGES

These two tax changes could be introduced in the same way that other tax changes are, with an announcement by the Treasurer that from the time of announcement all arrangements entered into involving investment in housing would be subject to the new negative gearing rules and capital gains change.

The effect of the two changes can be seen in an example where a prospective investor is thinking of buying a housing property for $400 000, of which $150,000 represents housing and $250 000 is the unimproved value of the land, by borrowing funds for the entire sum, on which the interest is 8%, and where the investor is paying the top marginal income tax rate of 48.5%.

On the negative gearing change, under present circumstances, the 8% a year cost of the investment would be fully deductible. Under the proposed change, only half ($150 000 housing element plus $50 000 standard land element) of the total cost would give entitlement for deductible interest, so that instead of deductibility of 8% of $400,000 at 48.5% there would be 8% deductibility of $200,000 at that rate, and no deductibility for the 8% interest on the other $200,000. The difference in terms of return on the investment would amount therefore to about 2.0% worse, in this particular case. The higher the land component of the property, the greater would be this disincentive effect, and the lower the land element the less this disincentive effect. For instance, in the case of investing in low cost housing where the land element in each dwelling unit was $50 000, there would be no disincentive effect from this change.

The difference with regard to the capital gains tax change depends essentially on the investor's perceptions about likely gains over the years ahead. It is commonly believed that the long-term capital gains of housing investments (essentially from the land element) range between 7 and 10% a year. Assuming this range applies, the effect of this change would be to reduce the yearly return rate from capital gain, at the top marginal tax rate of 48.5%, from 7 to 10% minus 24.5% to 7 to 10% minus 48.5%. This means capital gain per year would fall from about 5.25% to 7.5% to about 3.5% to 5%. or a fall in return per year of about 1.75 to 2.5%.

Adding the two changes together it can be seen that for property with a high land component of value, the fall in return would be 4.5% or higher, while for low cost denser housing the fall would be 1.75% or even lower, possibly no fall in return if the acquisition had no capital gain factored in as a financial justification but was relying simply on rental income for return on investment.

The effect of these two changes would be to largely remove investment by non-owner-occupiers in middle and higher value housing, that is where the land element in value was relatively high. These changes would have little or no impact on investment in low cost housing for rent. In effect, market values for housing would be set by those bidding for housing for the service that it offered as housing, not as a vehicle for capital gains by buying residential land.

Currently there is a housing boom, fed apparently by the perceived better returns from investment in housing rather than in other assets, following the recent share market downturn. Because of the abrupt change it might make to the present 'housing boom', with consequent collapses in confidence, now would not be the time to introduce such change. In time the boom will ease, and this would be the time to introduce the changes, as housing prices hopefully would enter their typical plateau era for some years. If introduced at this non-boom time, the effect would not be dramatic. House prices would not fall greatly, as house owners typically just withdraw their houses from sale if there seems less demand around, which would be the effect of these changes.

In the longer term however, these two tax changes would have the effect of lessening the amount of finance bidding for housing, with a gradual fall in the real prices of housing, perhaps masked by stability in money values, and a gradual improvement in affordability. Prices over time would come to reflect the value of housing as housing to consumers, not as a capital gains driven investment opportunity. As housing values are the main underpinning of the funds available to purchase housing, there would be a gradually cumulative effect of lower prices, a virtuous circle.

It has been often suggested that a gap in the capital gains tax regime is the complete exemption of the family home, which tends to encourage over-investment in owner-occupied housing, pushing up prices, and is an unjustified loophole for the wealthy. The proposed two tax changes would address this issue, at least partly, because the general effect of lowering prices through discouragement of investors would make capital gains by owner-occupiers less.

Quite apart from the immense social benefits of improved affordability, these changes would have the effect of making national economic management of the economy easier, and assist national economic goals. House building would continue as a key industry, but more smoothly in answer to consumer demand, not investor frenzy. With a relative lowering of housing prices, so that they reflected earnings not speculative gains, investment in housing would become a low risk, secure, highly reliable form of investment with good yields. This would ensure continued levels of investment in rental housing.

OTHER TAX ISSUES

BUILDING DEPRECIATION

Currently investors who own buildings built since 1985 are able to claim a depreciation of 2.5% of the construction cost a year as a deduction against tax. The total cost of the building can therefore be claimed under the tax system over forty years. Under the tax system , however, the full cost of repairs and maintenance is deductible, and given that a properly built housing structure if fully maintained and repaired will last far longer than forty years, this deductibility of the construction cost seems to be a case of allowing deductibility of something that is not a current cost of earning assessable income, but rather a non-depreciating capital cost. This therefore seems contrary to the principles of the Australian tax system, and an unjustified subsidy via the tax system for investor owners relative to owner-occupiers. Its abolition would seem to assist affordability for owner-occupiers.

It might be argued that this measure is justified as a subsidy for the provision of rental housing, which serves a social need by increasing the supply of housing for renters. There is pressing need for more rental housing at the low income end of the market. However, this seems a badly directed form of tax expenditure if this is the aim. Clearly the more expensive the housing form, the greater will be construction cost to be claimed as a deduction, and normally housing shortage is not at the higher income end of the market. Most of the cost of this concession would have no benefit for low cost housing. It would be better therefore if this concession were abolished, and the savings directed specifically and therefore much more effectively at increasing the supply of low income housing for rent.

☙GST

In the public discussion on housing affordability, one of the arguments has been that the introduction of the GST to housing construction was a significant driver of worsening affordability. As house construction activity and most of the components of a house were free from taxation prior to the GST, the imposition of a general value added tax (the GST) to that form of consumption led to an almost 10% rise in house construction costs. However, as noted the problem of housing affordability is essentially not a problem of housing construction cost but of the price of residential land, most of whose construction cost to make it usable was incurred years ago. The worse is the affordability problem, the less is housing construction cost an issue. In a new urban area where the cost of a new home is $150 000 house construction cost and a $150 000 land cost set by the residential land market largely unrelated to construction costs of bringing the land component onto the market, the abolition of the GST would probably only result in a fall of 5% of total price.

Also, there is scope for flexibility in absorbing the GST cost of house construction. Given the very large size of many new houses, it is possible to build a house that is slightly smaller, and absorb the cost of the GST, with a view to extending the house in years to come if and when home-ownership burdens lessen as part of income. The GST was designed as an across-the-board value added tax on consumption. There seems no convincing reason why housing consumption at the time of construction should not be part of overall taxed consumption, that is, why house construction is a special form of consumption. Housing affordability is essentially land market problem, where the GST has very little impact, and housing affordability should be addressed through other, better tax changes, not via the GST.

☙STAMP DUTIES

Stamp duties on the sale of properties has been raised as a reason for worsening affordability. However two reasons suggest this is not a significant factor. Firstly, stamp duties are not a very large part of the average cost of a dwelling, overall, usually well under 5% of price. There are also concessions on this for first home buyers. Secondly and more importantly is the fact that in the market for residential land (in established or new housing) there is virtually zero price elasticity of supply. In other words, increased funds by buyers through abolition of stamp duty will bring on no greater supply, the sellers market will continue, and the funds made available by stamp duty abolition will end up in higher prices.

Stamp duty is a major source of revenue for state governments. To the extent that stamp duty abolition would weaken state governments ability to address the urban planning and urban strategy steps discussed below, it would weaken other steps needed to improve affordability.

LAND TAX

Land tax is also a significant revenue source for state governments. Typically it applies at a rate of 1% or slightly more a year on the unimproved value of non-family home land. It amounts therefore to a small disincentive to investment in residential land. It could be argued that a way to reduce investment in such land and so improve home owner affordability would be to increase the level of land tax significantly. However there are some major objections to this.

Firstly, it would have the appearance of retrospectivity, that is, it would not apply just to new investors in residential land but to all existing commercial land owners, and would thus have an effect on decisions made in the past. Secondly, its ramifications would be widespread, affecting all forms of commercial land, wider than the housing market. The effects might be hard to predict, or unintended. Thirdly, when land tax was introduced in the ACT about five years ago, there were widespread claims that it had the effect of forcing up rents on tenanted housing. It depends on the circumstances whether this would be the case with an increase in land tax, but it would probably be the case where there is a shortage of rental accommodation, a sellers market, which is certainly the case generally in Australian cities with low rental housing.

Land tax should certainly be retained and possibly gradually increased, but it does not offer the advantages in addressing affordability of the two major tax changes proposed above.

SHARED EQUITY PROPOSAL

A proposal has been put forward in the report by Joye and Caplin on home ownership, published by the Menzies Research Centre, that the housing affordability problem be answered essentially by financial institutions providing a substantial part of the price of a house, sharing the equity to say 30%. The home buyer would therefore find it much easier to save the deposit and meet the repayments on a loan, having to meet say only 70% of the price. In exchange the financial institution would have no income from its contribution to the cost, but would be recompensed by receiving a large share, to be negotiated in the agreement with the home buyer, of the capital receipts upon sale of the house.

The report also proposes measures to complement this demand-side measure, improve the supply of housing, by way of a greater level of land release in urban areas, and measures to oblige local governments to allow redevelopment so as to meet targets on increased density of housing in established urban areas. These supply side issues are discussed further, below.

The shared equity proposal seeks to address the serious financial issue in high housing prices, that families have to enter the housing market with the heaviest financial burden at an early stage when incomes are often lower than later in life, financial resources have not been built up, and when income may be further drastically lowered further by time off to have children. Perversely, later in life, when these demands have lessened, wealth in the form of equity in housing is greater. However, this housing equity is in a highly illiquid form, which may not be easily accessed at a further stage in life, retirement, when it would be most useful. The shared equity proposal seeks to address these imbalance problems by proposing in effect that the family have less financial burden early in life, balanced by less wealth later in life upon sale of the property.

While it might seem a positive measure, this proposal has some serious flaws which render it unlikely to solve the housing affordability problem. Firstly, if this approach were widespread the net effect would be to draw higher levels of overall savings into the housing, and hence essentially the residential land, market. This is because it is unlikely that the home-buyers participating in these schemes would in fact limit themselves strictly to borrowing the reduced share of financing they would need. They would be tempted to increase their share to some extent, even if not to the whole extent of funding by the financing partner. This greater level of funds for housing would push prices higher than otherwise, and make the housing market even more attractive to investors, so building a cumulative effect on values. Overall this would lessen to some extent the expected beneficial effect on affordability.

More significantly though, the widespread use of this form of financing would mean in effect a huge expansion of house financing dependent on capital gain. This form of financing would therefore be like current negative gearing investment in an extreme form. The financing lender would receive no earnings over many years, until the home owner decides to sell. This may be for 20 or 30 years. An increasingly large capital gain upon sale will be needed to justify the lack of earnings over many years, and the prospect of capital gain would be dependent on when the home buyer wants to sell. In other words if they decide to sell at the wrong time in the housing cycle there is a risk of inadequate capital gain. This in other words is a hugely risky form of investment, earning no income year by year, dependent on very high residential land capital gains continuing over many years.

At present, financial institutions provide finance for housing in ways that produce earnings for them and minimise risk. Owner occupiers pay the lenders based on their own incomes and desire to own their own homes, or investors finance borrowing on the basis of rental income plus the prospect of capital gain. However, risk is minimised by mortgage lending less than total value of the house. The shared equity proposal asks lenders to go far beyond this.

In fact there seems no major obstacle to this form of house financing being taken up now by financial institutions, but there seems no interest in it by them. They have preferred to serve their financial aims through the current housing finance methods. If they were financially attracted to getting into the residential land capital gains area more deeply, which is what this proposal involves, they could do this in a safer way, by buying property directly and thus earning rental income to provide an ongoing return to their shareholders or lenders.

This proposal if widely adopted would mean a significant part of the savings currently safely invested and earning income would instead be depending entirely on speculative capital gains in the residential land market for a return. There would be a large financial interest of the whole economy in ever-increasing values for such land, with cumulative effects as other investors were drawn into this area. Measures to slow the rise of residential land values would be attacked as financially dangerous. Overall it is impossible to see this approach as being widely attractive to financial managers, or as an answer to housing affordability problems.

SUPPLY-SIDE ISSUES

PLANNING HISTORY

Traditionally the theory and the practice of town planning in Australia has centred on the release of land for urban development, and rezoning for higher density or other higher value uses in existing urban areas, with certain key physical and economic objectives in mind. Using techniques such as programming development works in the right order, and planning compatible and complementary land uses, at suitable densities, major objectives have been:

- efficient (reasonable cost) and effective provision of utility services such as roads, public transport, water and sewerage

- a suitable hierarchy of land uses such as schools, retail centres and other employment and community activities
- a workable relationship to utility mains and headworks, and to arterial transport networks
- good urban design
- enhancement of environment and heritage values, and avoidance of environment and heritage costs.

Essentially land use plans were put into effect by using the pressure of development by the private sector and government agencies to 'fill out' the plan. In other words, if there was not sufficient interest by development interests to use the land zoned, the orderly and efficient development envisaged would not occur. Within the established urban area, rezoning to other uses almost invariably took place as a response to development proposals. The alternative, of the planners positively promoting development themselves, by undertaking works ahead of demand and by providing incentives for other participants, was generally not undertaken because state agencies rarely had the financial resources to do so, reflecting a lack of need as perceived by state governments.

Historically town planning did not have as an important objective keeping land values low. For much of the past, when housing affordability was much better, this may not have mattered. Indeed, it can be seen that the fulfillment of plans actually depends on a certain level of development pressure. Such pressure would tend to generate higher land values. Conversely, looser or no land use planning would result in some worse outcomes, but possibly lower land values. Clearly the desirable objectives that town planning aims at still need to be pursued, but greater attention needs to be given to land values than has been in the past. Below are proposals on how this might be pursued.

DECENTRALISATION AND URBAN STRATEGIES IN AUSTRALIA

Australia as an offshoot of Britain began as a series of urban settlements which are the state capitals of today. Population spread to rural areas and to other urban centres, but after a high-water mark in the late nineteenth century, broadly Australia has seen a continuing concentration of population in a few metropolitan areas. Even in 1890 it was noted with amazement and concern that 50% of Victoria's population lived in Melbourne, a world record at that time for population concentration in one city for a large region. Currently concentration in a few metropolitan regions is continuing, with the one qualification that some coastal areas are experiencing strong growth based on income sources such as tourism, welfare and retirement.

Governments were concerned about this trend for much of the twentieth century, and pursued largely ineffective policies of closer settlement and decentralisation. The culmination of this interest was in the Whitlam Government's policies on urban and regional development 1972-75. Among other things, these policies were novel in that the Federal Government used its powers to improve the provision of services to outlying urban areas of the main cities, and for the first time promoted a series of new growth centres outside capital cities, such as Albury-Wodonga, Bathurst-Orange and Monarto, SA. This contrasted with previous decentralisation measures by state governments, which tended to be dispersed over many or all non-metropolitan centres.

However, the methods used to promote these entirely new urban growth centres did not include direct incentives for economic activity to move there. Rather these growth centres were promoted by coordinating local government and other administration, publicity, the location of a few government agencies, new overall town plans and planning agencies for these centres, provision of funds to improve utility services, and acquisition of key areas of land to facilitate planning and growth. It should be noted that the urban and regional policies of the Whitlam Government were carried out in close cooperation with non-Labor state governments such as those in power in NSW and Victoria at the time, and that the McMahon Government prior to the Whitlam Government, and the Fraser Government after, also pursued some of these policies.

By the end of the 1970s however these new growth centre policies were for practical purposes abandoned by federal and state governments, and proactive measures on existing urban fringes also received much lower priority from state governments. In the decades since, governments, especially the federal government, became preoccupied with macro-economic challenges, and these urban and regional policies came to seem quaint vestiges of a past age.

However, in light of the present problem of housing affordability, these policies of new growth centres to lessen the dominance of a few main centres, and better funded and planned expansion on the urban peripheries, seem prophetic. Had they been followed for some years the dominance of existing metropolitan areas, and the release of new urban land as an incremental activity on the fringe of these areas, might have been avoided. With a better network or hierarchy of centres, providing more alternatives for urban growth, and with a better managed process of land release, there might have been a better situation now not only with affordability of housing, but also with problems such as long journeys to work, high car dependence, air pollution and traffic congestion.

ELEMENTS OF A BETTER LAND RELEASE PROCESS

The incremental release on the urban fringe of land which is a poor substitute for most urban residential land in metropolitan areas, the present approach, will have little beneficial effect on affordability. What is needed is release of land which is a much better substitute for existing land, and land whose costs to house owners are kept down. Costs can be restrained as follows.

Preventing land hoarding. In a situation of very secure long term capital gains in urban land, it is rational for land holders of zoned land to hold off selling while waiting for further rises. This activity on a wide scale becomes self-fulfilling. Land hoarding can be a major factor in limiting supply. For instance, the Victorian Planning Department estimates that there is vacant land zoned for housing around the Melbourne periphery amounting to 15 years growth, but it is not being built, with consequent higher prices, due to hoarding (see article in the Australian Financial Review 9-10 August 2003). Thus in new areas a requirement could hold, as it does now in the ACT, that land subdivided and sold for housing must have house building commenced within one year of sale, or the sale is rescinded. (For land within the urban periphery, as in the Melbourne case, special rate disincentives to hoarding could be used to help address affordability).

Limiting development charges to a reasonable level. It depends on particular circumstances as well as philosophical views as to what is a 'fair' level of development charges on new residential areas. Given that new houses on the urban periphery will pay the same water rates, say, as existing housing, and that housing in established areas generally never paid large up-front capital charges for water and sewerage services, it can be argued that there should be no additional charge above standard rates. In other words, all such works should be paid for by loan funds which are then financed through rates. The same could be said even for local road construction costs, though not for local road land provision. Certainly there is no case for new subdivisions paying capital charges for water and sewerage headworks.

A general move against paying for works by capital charges on new developments, and towards using overall rate income to fund borrowing for works, means a change of attitude towards loan fund raising by utility bodies. The latter is not something that should be avoided or minimised as far as possible, but rather seen as the essential way for utilities to properly fund expansion, and as the fair way to finance this, including lessening pressures on new housing affordability. This represents a change of attitude from current prevailing views. Borrowing to fund essential urban works, with financing based on rates across an urban area, is financially very secure. Adequate funding of such works well up-front is also likely to be economically efficient, because properly planned and programmed urban works ahead of development are always likely to prove less costly in the longer-term.

Generally, development charges should be put on a consistent basis and lower than they have often been. However, this will not improve affordability if lower development charges simply result in bigger windfall gains for land sellers. The fact is that development charges have been used as de facto betterment taxes. Betterment is the increased land value from rezoning.

As betterment arises from a decision by government to rezone land, it has been often been regarded as an unearned increase in value which should accrue to society. The theory has been that a betterment tax should apply so that society via the government benefits to the complete extent of the increase in value. In fact betterment taxes have never been generally applied in Australia, except in the ACT with its unique form of land being leased rather than sold freehold. Currently in the ACT a 75% betterment tax is levied on the increased value of land when a new commercial lease is granted, with the remaining 25% seen as an incentive for development.

In a limited number of cases betterment has been collected by government in Australia by them acquiring land and then rezoning it to a higher use, but this has not been a widely used approach. The main way that some betterment has been collected, de facto, in a hit and miss way, has been via development charges.

Ensure lower development charges pass to home owners. The way to ensure lower development charges are passed on to home owners is for new land releases to be managed by a government agency whose object is to ensure affordability. This means managing the whole release process, to keep development charges low, to ensure a reasonable return to private sector participants, but to ensure land prices remain low for new home owners. It may mean that the land is acquired by the agency, but it may be achievable by rules such as that building must commence within, say, a year, to avoid land hoarding. To be managed properly to keep prices low it requires release of attractive residential land on a large scale. If competition from would-be home owners still pushes up land values and results in betterment accruing to the land development agency, the money should be put aside to fund the infrastructure of further release areas, to maintain a large program of land releases, to further assist affordability.

NEW GROWTH CENTRES

Large scale release of attractive residential land, which will be a good substitute for existing urban residential land, means new growth centres. These may be on the fringes of major cities, or they may be based on existing smaller cities further from the main cities. The most fundamental need in new growth centres is employment. If these centres are on the fringes of existing cities employment may be greatly assisted by good transport to existing urban areas, both road and rail. Land needs to be provided for employment generators in new centres, such as commercial centres, educational institutions, manufacturing, or transport-based industry. It may be that support in the form of employment incentives or location of government agencies will be needed to assist employment. All this implies new urban strategies for Australia.

Given the importance of housing affordability to households, if these new centres can offer very good affordability, it will be a incentive for population to move there. Thus the labour force available in such centres will be a selling point for other land uses, and hence employment, to move there. As noted, this approach means that the managing government agency and utility services need the ability to borrow heavily to fund these longer term approaches, and government will need to spend on incentives to make these new growth centres succeed.

The Commonwealth Government has a dominant role in the finances of government in Australia, through its dominance of revenue collection, its continuing funding of the states through specific purpose grants, and through the operation of bodies such as the Grants Commission. Also, when new policy issues arise for the states, especially those involving funding, there is a need for leadership for the states, because they tend to compete and new burdens for some can give rise for other states to try to take advantage of this. Further, Commonwealth Government has overall responsibility for economic and social needs in Australia, and housing affordability is an economic and social issue of the first importance. For these reasons the Commonwealth Government needs to provide support and leadership for the states in developing those urban strategies which are essential in improving housing affordability.

URBAN CONSOLIDATION

Increased housing densities in established areas (urban consolidation) has become a popular policy with state governments in Australia in recent years, but has often faced great difficulties in being implemented at the local level. Support for consolidation has been driven largely by the belief that servicing costs of all kinds for urban populations will be lessened, taking financial pressure off utility providers. Despite this cost basis for supporting consolidation, it has not been driven by a desire to improve housing affordability as such, and in this respect perceptions by governments have been correct, because it is a rather qualified answer to improving affordability.

There are several reasons for this. First, if consolidation means replacing detached houses with apartments or town houses (rather than filling in unused undeveloped land, or changing the use of non-residential land to residential), while increasing the supply of denser housing units, by replacing detached houses it decreases the supply and thus worsens the affordability of the latter. It is also possible that greater population in an area from higher density may also lead to housing land being turned over to more land for retail or roads, say, so further decreasing detached housing supply.

Second, while the cost of the land element is the predominant cause of worsening affordability, to the extent that construction costs are a factor in affordability, high density housing is more expensive than detached housing. Also because redevelopment is often a more complex process in various ways than new development there may be various transaction and obstruction costs.

Third, higher density developments may not result in lower utility servicing costs per head than greenfields developments (in effect through using spare capacity), but may give rise to higher costs because of the need for augmented utility services for higher densities. For instance, sewer mains built decades or more than a century ago in older parts of cities will cost far more to augment than building new sewer mains in greenfields situations. If development charges for new higher density developments are related to the costs they generate, this may add extra cost to higher density developments.

Fourth, replacing existing housing means absorbing the value of the demolished housing into the cost of the new units.

Lastly, because of these obstacles and higher costs, market -driven urban consolidation occurs largely when the price of housing generally is rising, which forces up the land cost in higher density replacement housing. Conversely, market driven consolidation tends to slacken off when housing prices ease.

Taking all these cost into account, the effect is that under various density and house price scenarios, urban consolidation does not tend to produce 'housing bargains' especially for low income earners. It tends to produce housing which is at least middle range in price (while at the same time not providing the open space of detached housing). New higher density housing tends to be much more affordable, or for low cost income earners, principally when it involves a striking increase in density with a relatively low price of the housing it replaces. These conditions do not hold for a great deal of current market-driven higher density development. While any costly inefficiencies in the administration of urban consolidation should be addressed, it is doubtful therefore if urban consolidation can be relied on greatly to improve affordability, even if forced politically.