December 7, 2003

Productivity Commission
LB2 Collins Street East
Melbourne, Vic, 3000

Dears Sirs/Madams

**Re: Inquiry on First Home Ownership Affordability**

The federal Treasury's "Economic Roundup, Summer 2003-04" contained a paper titled "First home buyers in Australia" (by Mark Rodrigues). The paper focuses on arguments that support a proposition that "the magnitude of decline (in first home ownership affordability) appears to have been overstated by some summary measures of affordability". Many of these arguments are good and relevant.

However, the paper fails to discuss (let alone analyse) those shortcomings of "summary measures" which may not support Treasury's proposition – i.e. where these measures may have the effect of overestimating affordability. This reflects badly on Treasury as the paper presents unbalanced arguments. The paper also does not address some significant economic issues surrounding a couple of its own findings.

Neither "summary measures" nor the Treasury paper address a number of factors which affect "affordability", including:

- Household expenses. The reality is that not all income is available for loan repayments. New spending commitments (e.g. HECS, road tolls, computers, Internet, mobile phones, pay-TV, education fees, child care, health expenses etc) and/or higher taxes may have had an adverse effect on affordability over recent years – particularly for people in the age group that typically comprises first home buyers.

- Scheduled loan repayments are based on current variable mortgage interest rates, rather than on a "normal" rate. Official interest rates are reportedly rising toward a "neutral" or "normal" rate, and mortgage interest rates are following. With interest rates rising, more borrowers are entering into fixed interest rate agreements, at rates which usually exceed variable rates. Moreover, in the event of a major shakeout in the housing market, lenders may seek to recoup any losses from loan defaults by increasing interest rates.

- Casualisation of the workforce, which adversely affects prospective first home buyers' perceived levels of affordability.

- Higher debt levels and a long term increase in the average age of borrowers. "Summary measures" take a snap shot in time approach to affordability and do not take into account long-term affordability. It is not only relevant for borrowers to meet loan commitments in the first month of a loan contract, but also over the full term of the loan contract (i.e. paying a mortgage in full).

- Economic activity. Currently, "summary measures" may be calculating affordability at the top of the economic cycle. It is probable that high household debts (along with home equity withdrawal) have brought forward some economic activity, and future economic growth (and employment growth and household incomes) may not benefit to the same extent from growth in consumer spending.

- The ability to save an adequate deposit (e.g. in view of other commitments such as HECS, and low interest rates).

- The apparent decline in birth rates (and the likely impact that "affordability" has on birth rates). This should ring alarm bells at Treasury in view of the work Treasury has done in the area of intergenerational issues.

The Treasury paper asserts that an increase in the availability of finance has increased affordability. That is only true if borrowers are able to meet their future loan commitments without undue stress.

While mortgage default rates are currently low, there is an expectation among some commentators that default rates will increase. This may occur as a result of a rise in interest rates, a fall in housing prices and/or a rise in unemployment.

The paper points to a long-term increase in the proportion of first home buyers who live alone. Such households may be subject to higher risk of loan default (due to the lack of a second income in the event of sickness or unemployment), so that long term affordability may, on average, be lower for this group of households, compared to couple households.

The Treasury paper states that many first home buyers are in an age-group (e.g. in the 25 to 44 year age cohort) which includes a relatively large proportion of high income earners (i.e. in the top 3 income quintiles). The paper also asserts that the distribution of income among this cohort has "remained broadly unchanged". Nevertheless, from the data presented in the paper, there is an obvious trend decline in the proportion of people in this age cohort who are in the fourth income quartile. Moreover, these are generalized observations and are based on data up to 2000-01 (i.e. two-and-a-half years old). There is a need for more stratified information on first home ownership affordability.

The paper states the First Home Owners Scheme "enabled a small number of people, who may never have become home owners, to purchase a home" but does not identify their characteristics or quantify the "small number". The paper's demographic breakdown of first home buyers is limited to ABS data up to the year 2000-01. The HIA/CBA Affordability measure commenced its major decline after June 2001.

It is intriguing that the paper's demographic breakdown of first home buyers is limited to the period ending 2000-01. This writer expected that more recent data would have been available to Treasury from applications for grants under the First Home Owners Scheme. Such data, if it is available, would also provide more recent information on first home buyer activity.

Yours faithfully

Nigel Fitzpatrick