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

RESPONSE TO DISCUSSION DRAFT

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SUMMARY

- Affordability of housing has clearly become worse over the long term in Australia. Rising real prices have outstripped rising real incomes. Real interest rates are now little lower than in earlier decades and thus differing costs of borrowing do not negate this disparity.
- Various indexes in the draft discussion draft which are inconclusive on longer term affordability trends, while useful in showing short term changes in affordability, are flawed as measures of long term trends, for reasons mentioned in the draft and for other reasons.
- Periodic steep rises in house prices are not cyclical in the sense that price falls later offset rises. These periodic house price booms, because they are followed mostly by a plateauing of prices, rather than falls, are the means whereby prices rise in the long term. The effect is more a ratchetting up than a cyclical effect. The current price boom will therefore help to maintain, and in fact greatly strengthen, the trend for long term housing price rise in relation to incomes.
- Ownership rates have held up well but there are indications of a falling off prior to the present boom. Because its effects will largely remain, the current boom will contribute to a further long term drop in ownership rates.
- Over the years 1970 to 2000, the average real (constant dollar) price of housing doubled. At the same time the area of land per average dwelling unit fell, and size of dwellings on average only rose marginally because pre-1970 housing stock remains significant. Consequently, it is hard to see any material increase in value to match the real price rise.
- In real terms, therefore, the housing market to a large extent does not operate to create new material wealth to meet rising real wealth demands. Instead it mainly acts as a transfer mechanism to allocate real wealth, after much market churning and transaction costs, essentially from those buying into the market to those exiting the market. It acts therefore as a mechanism to significantly increase wealth inequality largely unrelated to income (and thus effort), but rather in relation to position in the urban land market, in whatever way the latter has come about.
- This submission supports the specific recommendations of the discussion draft. However, the current boom is due to a significant extent to capital gains tax and negative gearing tax rules, and these tax arrangements are likely to continue to worsen housing affordability in the future.
- The inquiry should therefore strengthen its current findings and recommendations, along the lines that current capital gains tax and negative gearing tax arrangements are likely to have had a significant impact on worsening affordability, that this is likely to continue, and that consequently a review of these tax arrangements in their broader context should be undertaken because of the effects of these arrangements on the housing market, which are a major part of the broader contexts of these two taxes.

INTRODUCTION

The discussion draft gives a clear indication of the directions the inquiry is taking. Rather than revisit the whole issue and go over the issues raised in this author's first submission, this response therefore focuses on specific issues in the draft, and seeks to build on it, with recommendations about its conclusions.

Affordability concerns two main aspects.

- The proportion of incomes that buyers are obliged to spend on housing to achieve what they consider a reasonable standard of housing for themselves. This aspect is important in terms of wealth redistribution in society through the housing market. If a rising proportion of spending is on housing, as seems to be the case from various evidence in the discussion draft, the financial beneficiaries will include the house building industry but will primarily be owners of exisiting housing, because spending on new dwellings is a small part of overall housing spending. That is, the housing market is mainly concerned with asset exchange, not adding to supply.These existing owners will tend to be the older and wealthier sections of society. Thus the housing market is increasingly a mechanism for redistribution of wealth towards greater inequity based not on income (and thus effort) but on asset holding.

- The proportion of households that never achieve home ownership nor the various long-term financial and other benefits that ownership brings. Significant growth in this proportion of households would have widespread social and economic costs to individuals and to society.

While these can be seen as separate aspects of affordability, they obviously relate to one-another: a rise in the cost of buying as a proportion of income will exclude at the margin households unable to enter the housing market as buyers. A lessening of this cost will increase the home owning proportion.

LONG TERM RISE IN THE COST OF HOUSING

Figures quoted in the draft show a long term rise in housing costs, expressed as median house prices in constant dollars (pages 16 and 17). They show house prices in these terms doubling in the thirty years 1970 to 2000 (disregarding the much more dramatic rise in house prices in the last three years or so). This is reflected in the estimated rise per annum in real terms of house prices of 2.3% a year. The draft report notes that this rise is exceptionally high by international standards.

At the same time real household incomes have risien at a much lower rate a year of about 1%. On this basis house prices in 2000 were about 40% higher in relation to incomes than they were in 1970. On this basis affordability has apparently become steadily worse, prior to the extraordinary rises of the last three years. The underlying trend is for this worsening to continue, because there have been no discernible developments to undermine this trend. In fact, developments in recent years, noted by the discussion draft, such as the change to capital gains tax as regards individuals, and urban containment policies being followed by governments, seem set to strengthen this trend.

COST OF FINANCE

It is argued that because the main cost of acquiring a house is the interest cost on borrowed funds, the fall in nominal interest rates during the nineties has offset this rise in relative cost, and that affordability cannot be said to have become worse. However, this ignores the real interest rate, after allowing for inflation levels. In fact real interest rates now are little lower than those of twenty years ago (see figure 3.1of the discussion draft). This similarity of real interest rates means that the lower cost of finance argument does not disprove the contention that houses are significantly more expensive in relation to incomes than 20 or 30 years ago. It remains the case that affordability has become progressively worse in terms of proportion of income having to be spent on housing.

MEASURES OF AFFORDABILITY FLAWED

The draft discusses a number of indexes on pages 23 to 27 which endeavour to show changes in affordability of housing over the last fifteen or twenty years. These show little worsening if any of affordability, and may have provided support for the draft's lack of any clear conclusion that affordability had worsened in the long term.

As the draft notes, there are a number of reasons why these indexes do not reflect affordability changes well, such as changes in housing stock. However, there are two reasons worth mentioning in particular why these indexes are not useful on long-term affordability changes, that is, they do not measure changes in housing monetary values (and hence the total price home buyers face) relative to money incomes.

First, several of them relate 'typical' loan sizes to various forms of money income measures. As the draft notes, there has been an increasing tendency over the years for households to 'trade up', that is, use the equity they have built up in their existing home, and buy a more expensive house with that equity and with the benefit of new mortgage. This is in contrast to earlier times when this was less common, and it was more common for households to have only one mortgage during the lifetime of a household. The effect of having two or more successive mortgages, for progressively more expensive housing, is obviously to prolong the period of heavier mortgage payments, and ultimately to have to pay much more for housing acquisition. This trend towards multiple mortgages, rather than one, is consistent with households nowadays having to start home ownership with something less than satisfactory, say a flat rather than a house, and ultimately achieving their goal at a later stage.

What this trend towards more mortgages means is that the typical loan used in the indexes is progressively less reflective of average housing monetary values and the amount households pay over their lifetime for average house acquisition. These indexes are progressively less useful therefore, and increasingly underestimate worsening housing affordability.

Second, reinforcing this effect, is the fact that median prices for houses based on numbers of sales tend to underestimate the prices of housing overall. This is because of the truism of real estate that a high priced house is far harder to sell and takes much longer than a low priced dwelling. Sales are far more frequent on a given number of low-priced dwellings than on a given number of high-priced dwellings. Consequently, a house price figure based on an equal number of sales above and below that figure would tend to be well below an arithmetic average figure. This underestimation of average housing values would not matter in terms of trends in affordability, except that it reinforces the effect of the 'trading up' trend referred to previously, as regards the affordability indexes. As households increasingly start with a low-priced dwelling, the proportion of lower-priced dwellings being sold compared with higher priced dwellings willl gradually increase, thus gradually making the indexes based on median prices even more unreliable.

The quoted indexes are obviously valuable as short-term measures, but it is clear for a range of reasons that they are unreliable as affordability measures over decades, and should not be used to conclude that there is nothing to be said about worsening long term affordability.

'CYCLICAL' CHANGES IN HOUSE PRICES

The draft emphasises that house prices go through cycles, and it concludes that the current phase of steep rises will pass and clearly draws comfort from that. Various graphs in the report clearly show that historically there have been several sharp price rise periods, followed by substantial periods of price stability. While this is clearly a cyclical process in one sense, it is important to recognise that it is not cyclical in the sense that in time the falls roughly equal and hence, over time, offset the rises. In this respect 'cyclical' can be a misleading term.

The process is more an historical 'ratchetting up' process, whereby prices rise steeply for a shorter period, followed by a longer period when they do not fall, or fall by much less than in the rising period, but rather stabilise, broadly maintaining their value in real terms. The effect therefore, smoothing out these rises and plateaus, is for a long term rise in real terms, which the draft report notes. These price rise periods therefore have a long term effect in that they are not offset greatly by falls.

The conclusion is that such steep price rise periods cannot be regarded as passing, cyclical phases, but must be recognised as crucial to long term worsening affordability. If possible, measures that lessen this periodic effect would be beneficial as regards affordability, quite apart from other economic benefits they would bring if successful.

EFFECT ON HOME OWNERSHIP RATES

Various figures in the draft indicate that home ownership rates have held up well in the face of the rise in the relative costs of housing in recent decades. No doubt the very high priority given home ownership in Australia would have meant that people will grudgingly accept spending a rising proportion of their incomes to achieve ownership. Also, given this high priority and the nature of home ownership, an historically high level of ownership will erode only slowly.

However, there are some indications of erosion of this rate, for instance the two studies quoted in the draft on page 27 indicating a 2% fall between the early eighties and the mid-nineties. Also, figures published in the Australian Financial Review (November 8-9, 2003, page 4) based on Reserve Bank and other sources, on ownership rates by age groups tend to support the idea of a long term trend for lower ownership rates. These figures show that the highest owning age group is for those in their late seventies. Apart from a slight drop for those over 75, there is a direct relationship between age and ownership. Those in their late seventies for instance have an ownership rate of about 85%, which is about 8% higher than those, for instance in their early fifties, and about 12% higher than those in their early forties. Given the age at which housing is typically acquired, and the worse financial circumstances of those over 60, the explanation for these rates seems principally a long term decline in ability to buy housing, quite apart from the recent steep rise in house prices. The figures mentioned in the draft (page XIV), that during the nineties prior to the recent boom new home buyers in the top two income quintiles rose from 50% to 60% also support the likelihood of long term worsening ability to become a home owner.

RISING REAL PRICES VERSUS RISING REAL VALUE

According to figures referred to above in the draft, the real (constant dollars) price of housing on average doubled between 1970 and 2000. However, did the real value of the average house double over this time, or anything like it? In one major respect, that of the urban land component of housing, the real value actually worsened from 1970 to 2000. In housing in Australian cities nowadays, the value of the average dwelling unit is roughly fifty-fifty building construction and land component. That is, a modest three bedroom dwelling worth say $300,000 represents about $150,000 construction value and about $150,000 the area of land in a particular location. Since 1970, the gradual trend towards dwelling units without their own typical block of land (such as apartments or townhouses), plus the shrinking size of blocks in new developments (see page 93 of the draft) means that on average, there is less urban land per dwelling. Furthermore, on a metropolitan scale, new urban land on the fringes tends to be less convenient in relation to most attractions of metropolitan areas. The average value of land per dwelling in a non-monetary sense is clearly falling.

On the construction side, despite the addition of new housing stock which on average has been larger in square metres per person than older housing, the majority of the housing stock is still that built before 1970. Thus, even supposing all new housing units built since 1970 were substantially bigger than those exisitng in 1970, there would be much smaller addition to the overall housing stock through this. Assuming (generously) for instance that the average new dwelling since 1970 has been one-third larger than exisiting stock in 1970, and assuming (generously) that there had been a 40% addition to housing dwelling numbers since 1970, then average area per dwelling would have risen by only 11%.

Taking the worse value since 1970 per average dwelling unit in terms of urban land, together with the marginal additional value to the construction value of housing through larger new stock, it can be seen that there has been no significant increase in real value of housing, even as real prices have doubled. Thus steadily rising real incomes per capita have not translated into real increases in housing value in any material sense. In short, people generally are living in slightly larger average dwellings, with less urban land, in similar or somewhat less convenient locations, but having to spend twice as much on average in real wealth terms to buy into this market.

In terms of real incomes, the housing market therefore has acted more as a means of transferring real wealth increases, rather than in creating greater real wealth. Clearly, the main transfers are from those buying newly into the market, paying high mortgages, and the main beneficiaries, after much churning in the market and spending on transaction costs, are those exiting the market.

DISCUSSION

From the above it can be concluded that there is a long term rise in real prices for housing unmatched by any significant rise in real value. Price rises have also outpaced real income rises over recent decades, and this disparity has not been negated by interest rate factors because real interest rates are not dissimilar to those of most earlier years. Quite apart from the question of falling value for money, this means that those entering the housing market are paying an increasing proportion of their incomes to purchase housing compared with earlier years. Affordability has thus been worsening over recent decades.

Through real housing prices rising faster than incomes, the housing market, apart from its useful functions, is increasingly acting as a mechanism for greatly increasing inequality of wealth, unrelated to income (and thus effort) but rather related to position in the urban land market, in whatever way that has come about. Although home ownership rates are holding up well, available evidence suggests a long term weakening, quite prior to the current upsurge in prices which has greatly temporarily affected home ownership aspirations. Affordability over the long term is undermined by the ratchetting up effect of price rise periods, and the current unprecedented price rise period will therefore have a significant long term impact in worsening affordability and ownership rates. The present period of steep price rises cannot be written off as merely a cyclical price rise which will cancel itself out.

INQUIRY RECOMMENDATIONS

The draft report makes a number of recommendations that are positive, but which would not have a major impact on affordability in themselves. These are the recommendation relating to local planning processes, to stamp duty and to changes in the first home owners grant scheme.

The inquiry has understandably not made recommendations into some very complex areas which have wide ramifications apart from home ownership, such as urban strategies and regional planning.

The area where the draft report's findings could most usefully be strengthened relate to the issues of capital gains tax and negative gearing.

The draft report accepts correctly that the change to capital gains tax relating to individuals in 1999 must have played a role in the recent unprecedented price rises for housing. If this is the case, then the present capital gains tax arrangements are extremely likely to have a significant impact in worsening affordability in the years ahead. The draft report states correctly that tax changes need to be considered in the broader context of each tax, not just in relation to housing affordability. However it must be recognised that given the nature of Australian household wealth, the effect on the housing market of this tax are a very large part of that broader context, and a very strong ground for calling for a review of it. The draft report's recommendations should therefore include a strong recommendation for a review because of likely effects on housing affordability.

On negative gearing, the draft report notes phenomena such as the extraordinarily low commercial returns on residential housing as an investment form, and discusses the role of negative gearing in this context. It refers to a review of negative gearing, correctly, in the broader context . However, as with capital gains tax, the likely effect of negative gearing on housing affordability are a very large part of that broader context and a very good ground for review, and the inquiry's recommendations should be along such lines.

CONCLUSION

The inquiry should strengthen its current findings and recommendations, along the lines that current capital gains tax and negative gearing tax arrangements are likely to have had a significant impact on worsening affordability and that this is likely to continue, and that consequently a review of these tax arrangements in their broader context be undertaken, recognising that the effect of these arrangements on the housing market are a major part of the broader context.