



RBA ECONOMICS COMPETITION 2008

Housing Costs and Affordability in Australia

Second Prize

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Home ownership has long been the great Australian dream, however for some, gaining a foothold into the housing market is now proving to be a nightmare. The price of both home ownership and rental has increased greatly over the past twenty years, leading to declining affordability particularly for first home buyers and low income households. These sections of the population are being squeezed out of the housing market and facing severe housing stress, which poses economic and social consequences. This essay will outline and discuss the key factors contributing to Australia's rising housing costs and declining affordability. The role of government in addressing these problems and the implementation of suitable policies to cope with the housing crisis will then be examined to discover whether affordability in the housing market can be improved.

House prices in Australia have risen dramatically over the past two decades and despite the global credit crisis, Australian housing remains some of the most overpriced in the OECD (*Complex issues in home affordability 2008, 1; see Figure 1*). The house price to household income ratio was approximately four in 1987, though by 2003 the ratio had risen to nine (*see Figure 2*). Put simply, there is not enough upward pressure on wages to meet the rising costs of housing. Australian borrowers now require 38% of their family income to cover mortgage repayments with those in the rental market surrendering 24.7% of their incomes to rent (*Families spend quarter of income on rent, report 2008, 1*).

Contributory factors

The rise in housing costs is a result of increased demand due to Australia's booming economy and rapid population growth. In addition, Australians continue to receive higher real incomes and the number of double-income households has risen dramatically (*Housing Affordability 2008, 1*). Short term factors encouraging these price hikes are lower real interest rates and an easier access to credit as well as a tax system which encourages debt-financed property investment with incentives to purchase additional homes (*see Figure 3*). Greater investment in property and speculative activity stimulated by negative gearing and capital-gains tax concessions has led to the inflation of housing prices and the creation of a 'housing bubble' (Australian Council of Social Service 2003, 4).

Long term structural factors include the increasing privatisation of housing, a change in the structure of the population and changes in the labour market (Australian Council of Social Service 2003, 8). The demise of public housing provided and subsidised by government has

seen low income households faced with exorbitant rents in the private market. Although Rent Assistance is available to low income earners, many still face significant 'housing-related stress' (Yu 2005, 443). In addition, there is a gross lack of affordability within the private rental market as renting becomes a long term option rather than a transitional tenure due to the soaring price of home ownership.

The composition of Australian households is evolving with an increase in the number of single parent households and those needing aged care facilities. Therefore, there are now a greater number of households and the existing housing stock is not suitable for Australia's current needs (Australian Council of Social Service 2003, 8). Moreover, the labour market has changed, with part-time employment and shift work becoming more prominent and workers needing a higher degree of mobility. Households at the lower end of the housing market find it difficult to rent or purchase dwellings close to high employment areas, thus limiting their career opportunities and increasing the cost of commuting for employment. Viellaris (2008, 6) asserts that escalating housing prices have forced a third of buyers to purchase dwellings more than two suburbs away from their preferred location.

This increase in housing costs can also be attributed to supply problems as there is a shortage of land available for residential development, particularly in Australia's capital cities. Historically, most Australians have enjoyed homeownership, made possible by the availability of cheap and plentiful land for development (Beer, Kearns and Pieters 2007, 11). In addition, there is a lack of workers required to improve the supply of housing such as planners and construction workers, due to the existing skills shortage. This phenomenon again pushes up the price of housing construction and supply. There is also strong evidence to suggest that developers are exacerbating the problem by hoarding residential land for extended periods of time (Johnston 2008, 77).

Evidently, there is a mismatch between housing supply and demand due to the concentration of economic growth in certain locations, primarily capital cities. To improve housing affordability, the government has a major role to play in adjusting existing policies and implementing more effective strategies. By providing more Australians with the opportunity to own their own home, pressure on the increasingly tight rental market could also be eased.

Demand-side policy measures

Firstly, savings should be encouraged and rewarded in order to improve the size of housing deposits, thereby reducing the home buyer's reliance on debt to finance most or all of their purchase. This could be achieved by offering tax-free savings to first home buyers and low income earners which would provide an incentive for these groups to increase their savings towards the purchase of a home. Higher savings would thus increase the prospective buyer's chances of initially obtaining a home loan and being able to service that loan. This is imperative as recently, loan approvals for first home buyers have been waning (*see Figure 5*). This strategy would improve efficiency as it removes the distortions of tax, although it is inequitable as the tax exemptions on savings are limited to these particular target groups.

Secondly, in order to allow more first home buyers and low income households into the housing market, the number of properties being purchased by existing homeowners and investors should be curtailed. Therefore, the market would be more equitable and there would be lower demand for housing stock, potentially lowering the median price of housing. This strategy could be achieved by offering a disincentive for existing homeowners to use equity in order to borrow to purchase additional houses. A tax could be charged on borrowing against equity to be either levied on the financial institution providing the loan or the borrower themselves.

This tax would make the housing market more equitable as the amount of equity being used to finance additional homes would be reduced; thereby weakening demand and house price (*see Figure 6*). This policy would also aid in preventing over-investment in property and excessive debt levels during booms (*see Figure 4*). This tax however would pose efficiency costs because it is aimed at the choices consumers make, not their initial endowments per se, as stated in the Second Theorem of Welfare Economics (Varian 2006, 587). Taxes, such as this, are always a distortion to the economy and produce a deadweight loss, thus negatively affecting efficiency in the market. However the equity gains of these policies to those suffering from low housing affordability should potentially outweigh the loss of efficiency at the Social Optimum (*see Figure 7*).

Subsidies, too, aim to achieve more equitable outcomes in the market. The first home buyer's grant has enabled many entrants into the housing market however it has also been blamed for

rising house prices (Saulwick 2008, 3). In order to reduce the effect of the grant on the price of housing, the endowment should be means-tested to ensure only those earning a low income can access the grant. The amount of the grant could be dependent on the level of savings achieved by those eligible for the grant. This again would encourage higher savings towards the purchase of a home. By using precise targeting, the benefits of the government assistance are awarded only to priority groups, in this case low income households (Wood and Bushe-Jones 1991, 27). Clearly, this is a highly efficient proposal as it reduces the effect of the subsidy on house prices, although it does pose equity implications. By restricting provision of the grant to households with limited incomes, those first home buyers above the income threshold would miss out on the opportunity to obtain the grant.

Supply – side policy measures

To increase the supply of residential land available, fringe development is typically adopted by governments. However, it is an expensive option with higher infrastructure costs as well as higher transport costs for residents; particularly in the face of rising fuel prices (*see Figure 8*). In addition, there are also geographical constraints to wider fringe expansion. Alternatively, regional development should be encouraged in order to ease the strain on housing stock situated in the capital cities. The creation of ‘satellite cities’ with adequate infrastructure and employment opportunities would create more options for homebuyers whilst cutting commuting costs.

This policy could be achieved by initially offering incentives for both businesses and households to relocate to regional areas. In the short term, this strategy may pose substantial costs to government in providing improved infrastructure and services to regional areas however in the long run, the scheme would ease the pressure on housing in capital cities and contain the burgeoning urban sprawl. This scheme could prove highly efficient in the long term, provided there are enough residents and businesses relocating to regional centres. If the scheme is successful, it could also solve the problem of economic decline in regional Australia, caused by the loss of key workers (Australian Council of Social Service 2003, 8).

Along with home ownership, the price of private rental properties has also skyrocketed as more people are forced to rent when they cannot afford to purchase their own home. Investment has predominantly been focussed on higher end rental properties due to greater yields; however, there is a considerable need for more low-cost rental housing to meet the

needs of low income households. Rather than removing negative gearing and CGT concessions which would further restrict the number of rental properties available, greater investment in cheaper rental housing should be encouraged. A tax offset could be provided by government for private investors and developers who supply low cost rental properties. While this strategy does pose efficiency costs due to the distortions of taxation, it is a more efficient policy than investment in public housing which eats away at the government's budget surplus and provides a disincentive for low income households to provide their own housing. This policy is also more equitable as it removes the need for direct subsidies to certain sections of the population and provides more households with the opportunity to participate in the rental market.

Government prudential regulation agencies such as a viable Land Commission should be established in order to regulate the supply and price of land in order to discourage stockpiling and speculation by developers. The duration of time between the purchase of land and the commencement of construction should be constrained to increase the supply of housing and prevent land hoarding. Johnston (2008, 77) claims this can be achieved by taxing vacant, residential land to prevent speculation as well as requiring construction to commence within a set period of time subsequent to planning permission being granted. Although this scheme does require government regulation, viewed by some economists as creating inefficiency in the market, this strategy would prove highly equitable as it enables the development of residential land to be swift and more efficient, which in turn provides more housing stock for prospective home buyers.

To further improve the supply of housing, more personnel involved in the planning and construction of housing are required immediately. The government must facilitate more training and employment opportunities in these industries to encourage more people into the construction and planning industries. This goal could be achieved by generating more apprenticeships and training in the construction trades in order for this vocation to appeal to school leavers. In addition, more university places in engineering, architecture and planning should be offered along with scholarships to assist with the associated costs of study. Schemes to encourage overseas migrants possessing these skills and qualifications to Australia should also be established. These strategies would prove efficient as they aim to fill the skills shortage by acquiring the personnel needed to supply more land and housing to the

market. However they may pose equity implications as these benefits would only be offered to students and potential employees within certain housing-related industries.

Conclusion

Australia's rising housing costs have contributed to the declining affordability of housing, particularly amongst first home buyers and low income households. Lack of housing affordability is both a demand side and supply side problem with an insufficient supply of suitable housing stock to meet rapidly growing demand. The factors contributing to this dilemma include rapid population growth, higher real incomes and property speculation. The policies suggested in this essay aim to improve housing affordability for those in the lower end of the market by weakening the overall demand for housing. However, these strategies may only prove effective in the short term as any demand-side policy will eventually become inflationary. Thus, to improve housing affordability in the long term, government policies must be focussed on increasing the supply of suitable housing stock available. Perhaps then the Australian dream of home ownership can become a reality for more Australians.

Appendix

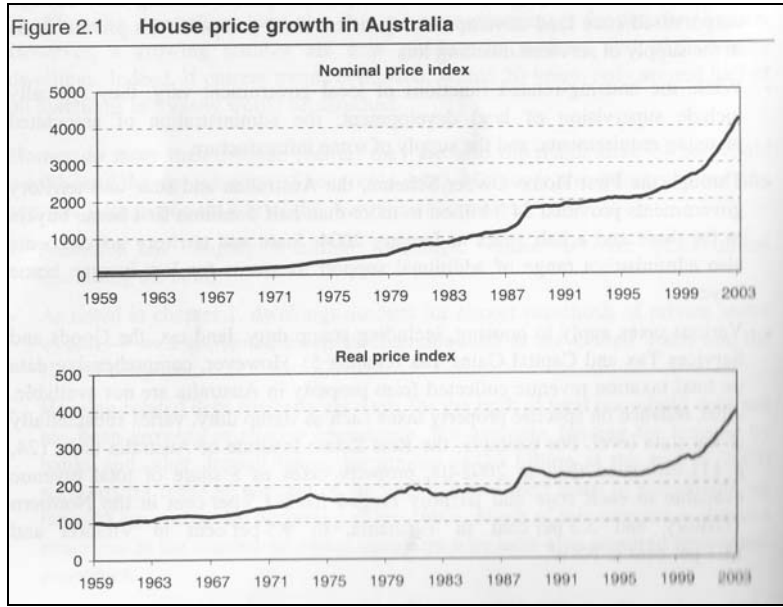


Figure 1

(Source: Productivity Commission 2004)

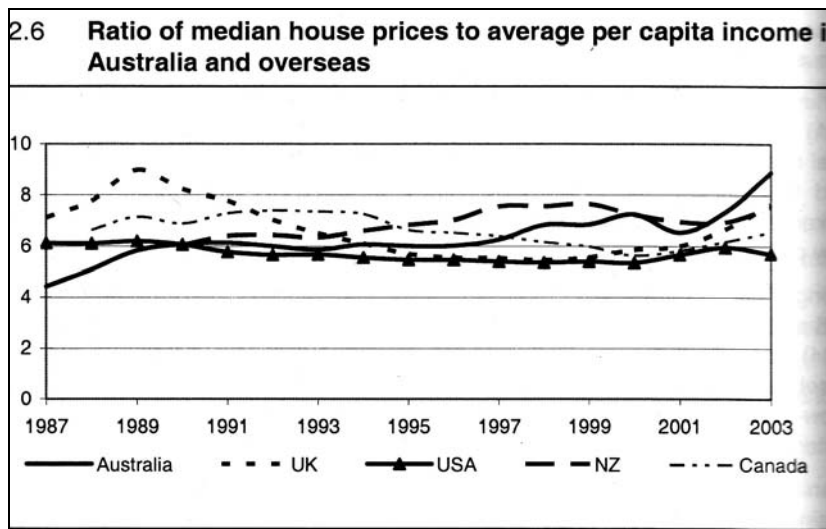


Figure 2

(Source: Productivity Commission 2004)

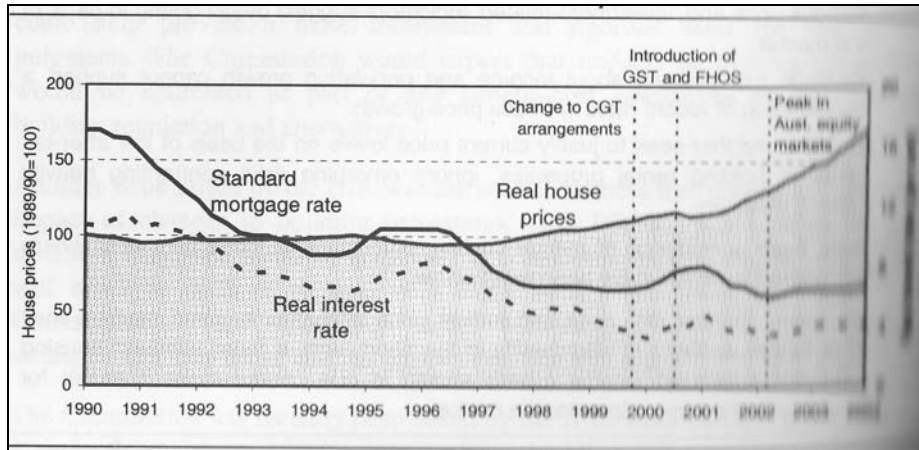


Figure 3

(Source: Productivity Commission 2004)

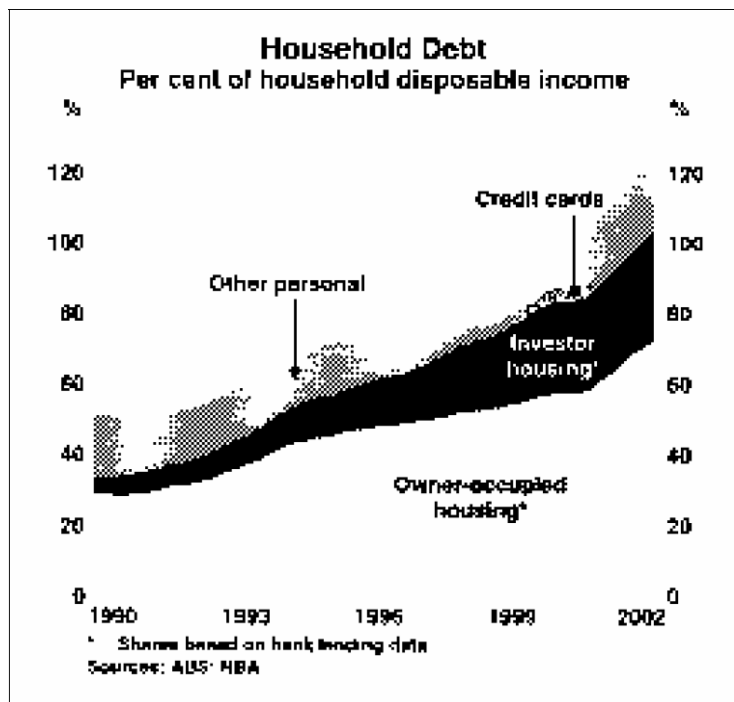


Figure 4

(Source: Australian Council of Social Service 2003)

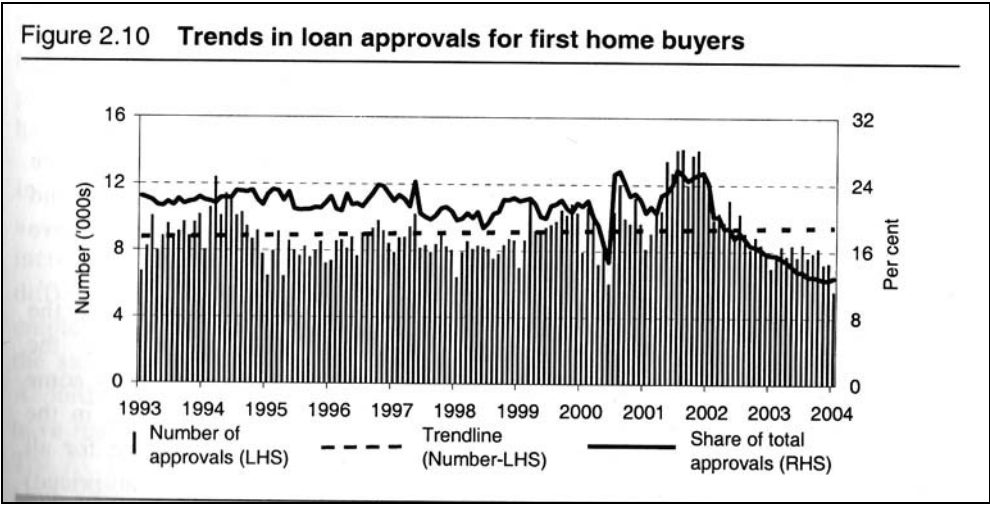


Figure 5

(Source: Productivity Commission 2004)

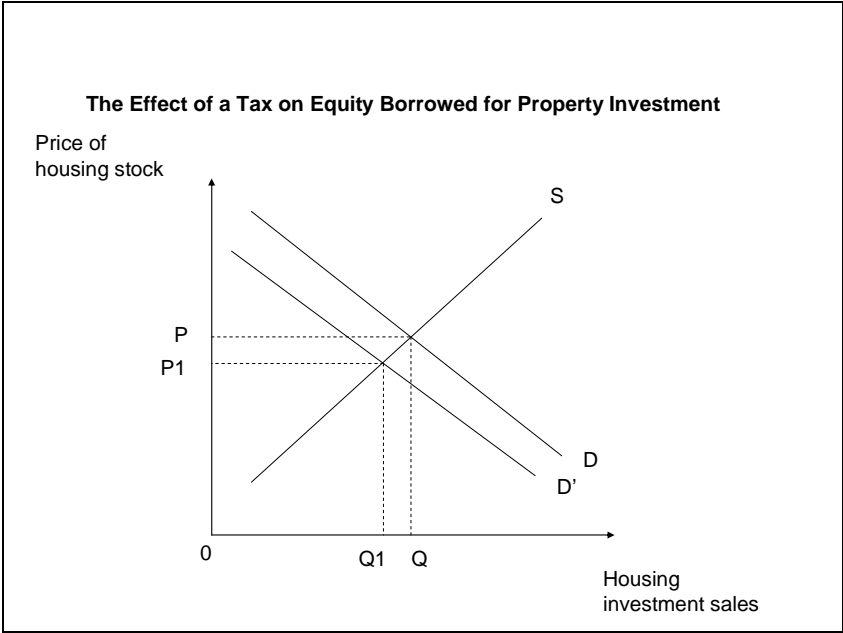


Figure 6

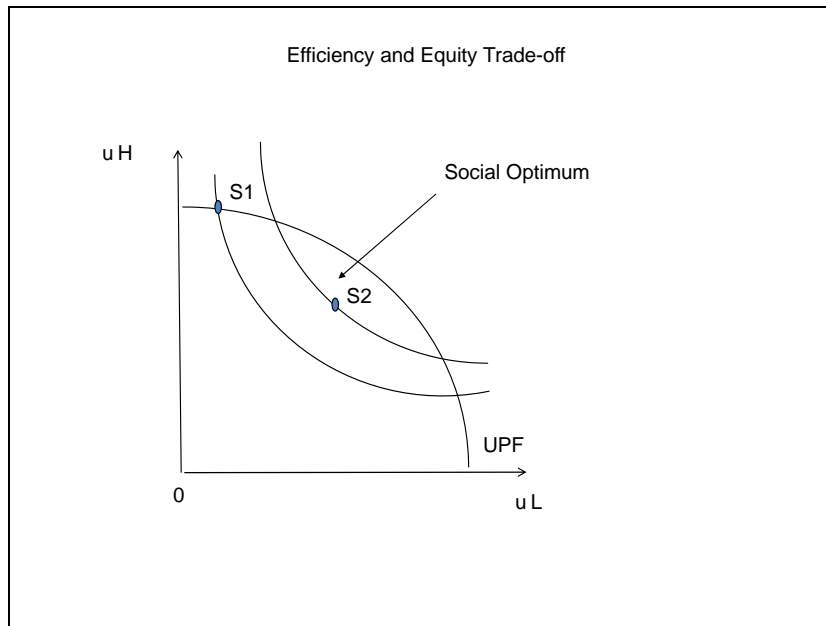


Figure 7

Table 7.2 HIA case study of infrastructure charges for a pooled set of greenfield developments in Sydney

<i>Infrastructure type</i>	<i>Dollars</i>
Basic infrastructure	21 825
Local drainage	600
Local roads	2 900
Local open space	7 000
Utilities	11 325
Major infrastructure^a	7 355
Trunk drainage	2 800
Main roads	2 700
Urban design and landscaping	1 855
Social infrastructure	6 737
District open space	1 800
Regional open space	440
Open space embellishment	2 170
Local community facilities	2 327
Total	35 917

Figure 8

(Source: Productivity Commission 2004)

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