

***PRODUCTIVITY
COMMISSION INQUIRY
ON
FIRST HOME
OWNERSHIP***

November 2003

***Submission by
RESERVE BANK OF AUSTRALIA***

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EXECUTIVE SUMMARY

1. The Reserve Bank welcomes the Productivity Commission Inquiry on First Home Ownership. The terms of reference cover a wide range of subjects. This submission will not attempt to cover all of them, as we would not consider ourselves to be experts in a number of these areas. It will confine itself to addressing the questions of whether housing is becoming less affordable for first-home buyers and, if so, why. The answer to the second question will provide a focus on areas for further examination or possible action.
2. In preparing this submission, special attention was paid to identifying those developments that were unusual by Australia's past standards, or unusual by the standards of other comparable countries. In order to accomplish the latter task, we held discussions with the relevant authorities in the United States, Canada, the United Kingdom and the Netherlands.
3. The central fact from which any discussion of affordability must start is that there has been a more than doubling in house prices over the past decade, and that strong price rises are still occurring. This is shown by all the indices of house prices, which also confirm that, unlike some earlier booms in house prices that were specific to certain areas, this one is Australia-wide. The ratio of the price of the average home to average income has risen sharply, as has the cost of servicing the mortgage if the home is acquired, making it increasingly difficult over recent years for first-home buyers to achieve home ownership.
4. The major reason that house prices have risen so much relative to incomes over the past decade or so is that interest rates on mortgages have approximately halved (comparing the second half of the 1990s with the second half of the 1980s). This structural reduction in nominal interest rates has been principally a result of the transition to low inflation. The housing market is an unusual market in that most purchases are made using debt. Because of the fall in interest rates, households have been able to afford to service much more debt, and this has greatly increased their purchasing power. This, in turn, has enabled them to compete with other households for more expensive houses. But this additional purchasing power is not confined to first-home buyers; indeed, existing home owners, with accumulated equity in their houses, have been in a much stronger position to compete than first-time buyers.

5. Mortgage interest rates have been relatively stable at a low rate now for the past half-dozen years. If the decline in mortgage rates for owner-occupiers was the only thing at work in pushing up borrowing and prices, then that trend should be tapering off by now, so that house prices would be rising by no more than could be explained by the underlying growth in incomes. Instead, house prices have continued to rise rapidly and credit to finance house purchases has been accelerating. So we must look for additional factors at work. The three main possibilities are:
 - there is a structural problem which means the supply of new dwellings is not keeping up with underlying demand;
 - various state and federal government taxes or grants have pushed up house prices;
 - demand to own dwellings as assets is being boosted to an unusual extent by considerations of expected returns, with households seeking an increased exposure to property through their own home and/or through purchase of one or more investment properties.
6. We have not examined supply influences in detail, but at the macro level there is not much evidence to suggest that the growth in house prices has been due to a persistent shortage of supply of houses relative to underlying demand for new housing. The two main determinants of underlying demand – population growth and the rate of household formation – have not been high by historical standards. Even though underlying demand does seem to have risen in the past couple of years, declining rental yields and rising vacancy rates suggest overall supply has at least kept up with demand. There may be mismatches between supply and underlying demand at the micro level, for particular types of housing (eg detached houses versus apartments) or for particular locations, and these factors may be important in explaining differences in price movements across the major cities. However, at an aggregate level these factors do not appear to be the main reason for the rapid increase in dwelling prices over the most recent couple of years.
7. The second possibility is that government activity in raising revenue or in assisting home buyers may have pushed up house prices. It has, for example, been asserted that state government stamp duty on property transfer has been a major cause. The pattern of stamp duty varies from state to state, and it is difficult to discern any economically logical basis to the system. In our view, however, stamp duty has not pushed up house prices, for reasons elaborated in the body of the submission. There can be little doubt, on the other hand, that when stamp duty is applied to first-home buyers, it increases the “deposit gap” they face, and thus makes home purchase more difficult.

8. It has also been suggested that the Federal Government's First Home Owner Grant (FHOG) and Commonwealth Additional Grant (CAG) contributed to the rise in house prices by adding to the purchasing power of first-home buyers. In our view, the net effect of these schemes has been clearly beneficial for first-home buyers through reducing the "deposit gap", and the effect on house prices has been minor. The FHOG was compensation for the effects of the GST, and the CAG was a temporary and effective means of shifting housing demand to a period of low activity from a period of high activity.
9. It is our view that the main impetus to the continued increase in house prices at present is from the third of the three possibilities noted in paragraph 5: an unusually strong desire by existing property owners for further exposure to residential property, either in their own home, or in an investment property.
10. The role of investors is particularly noteworthy in the current episode. For every new dollar lent for housing purposes, around 40 cents now goes to investors – a figure much higher than we have ever experienced before. The stock of credit outstanding is rising at nearly 20 per cent per year for owner-occupiers – an exceptionally rapid pace – but for investors the growth rate is closer to 30 per cent per year.
11. As a result, prices of residential property have been lifted to the point where the rental yield has reached an extremely low rate. At present, the gross yields are reported to be around 3½ per cent which means that, after payment of municipal rates, water rates, management fees, strata levies, maintenance, etc, the cash yield is around 2½ per cent or a little lower. The gross yield on residential property in other comparable countries is typically between 7 and 10 per cent. In Australia, the typical yields on industrial, commercial and retail property are 8–9 per cent. These are the sorts of yields required to get professional property investors to invest in property, yet households are investing at less than half these yields.
12. Thus, we find support for the view that investors have been contributing disproportionately to the increase in housing demand over recent years, with the effect that affordability, especially by first-home buyers, has been reduced. We accept that owner-occupiers moving to more expensive and better houses is also an important influence on prices, but it is the investor demand that is growing most rapidly.
13. The dominant role played by investors in Australia in the current cycle is the result of interaction between:
 - the desire of investors to earn capital gains from investing in rental property;

- the ease of obtaining finance to enter this activity; and
 - the taxation treatment of investments in residential property.
14. Regarding the first of these factors, there is a common belief that house prices cannot fall, or if they did, the fall would be small and short-lived. It is not surprising that this view – essentially an extrapolation of the past three decades’ experience – is so widely held. The fact that house prices have fallen noticeably in some other developed countries, or that at times they have fallen in real terms in Australia, does not seem to have shaken this belief. In addition, falls in equity prices and recent revelations of governance weaknesses in corporations and investment banks around the world have increased the perceived attractiveness of property relative to other forms of investment.
15. The second factor is the ease of obtaining finance. In earlier decades, investment in rental property was an option only for the well-off and well-connected because of the difficulty in obtaining finance. Over the past decade or so, finance for this activity has become much more widely available. Banks and other providers of finance are now eager to lend to households for investment purposes based on the collateral in their own homes. There is no longer an interest-rate penalty, low-equity and interest-only loans are readily available, as are split-purpose loans and innovations such as the deposit bond. The property investment seminar industry has expanded in a way not seen in other countries. The up-front cash cost of buying an established investment property is virtually nil for a household which has a reasonable amount of equity in its own home. For an “off-the-plan” purchase, the up-front cash cost is not much higher – about 1 per cent of the total purchase price if using a deposit bond. In examining these trends in the availability of finance for investor housing, we do not find evidence of a widespread deterioration in lending practices by financial institutions. Rather, these developments are the inevitable result of ongoing innovation and competitive pressures within the finance sector.
16. The third factor is the tax system and the desire for tax minimisation. In Australia, where the top marginal tax rate on income cuts in at a relatively low income (\$62,501), there is a large proportion of taxpayers who are attracted to investments which will lighten their tax burden. This has long been the case, and has recently been accentuated by the success which the property investment seminar industry has had in emphasising the tax effectiveness of property as an investment choice. A big attraction of property is the relatively modest after-tax holding cost of even a low-yielding property, due to the way that investments in rental property are taxed. In the body of the submission, we give some arithmetic examples of the low after-tax holding cost of rental property.

17. We wish to make it clear that we are not challenging the validity of the concept of negative gearing, whereby losses on one economic activity – in this case, being a landlord – can be offset against a person’s principal source of income. Negative gearing per se does not necessarily mean that the tax system is overly investor-friendly to rental property; negative gearing also applies to losses incurred on other assets. Negative gearing systems can be designed and administered with varying degrees of investor-friendliness, as the experience of other countries shows.
18. In fact, there are no specific aspects of current tax arrangements designed to encourage investment in property relative to other investments in the Australian tax system. Nor is there any recent tax policy initiative we can point to that accounts for the rapid growth in geared property investment. But the fact is that when we observe the results, resources and finance are being disproportionately channelled into this area, and property promoters use tax effectiveness as an important selling point.
19. To summarise the above, the key structural characteristics of the Australian housing market which distinguish it from markets in other countries studied in preparing this submission are:
 - a high proportion of individuals own rental properties;
 - a high and rising proportion of lending for housing directed to households for investment purposes;
 - very low rental rates of return on residential property;
 - plentiful availability and variety of credit available to investors;
 - an active property investment seminar industry; and
 - a tax system which is viewed by investors as assisting property investment.
20. Any policy response to the current difficulties faced by first-home buyers needs to take into account all of these factors. We set out some possibilities in paragraphs 21 to 25 below.
21. First, we have no specific suggestions for assisting first-home owners by adding to their purchasing power. However, if this path were to be chosen, it is important to remember that simply adding another source of purchasing power to the existing demand would lead to some further rise in prices. For this not to occur, any measures that add to

purchasing power need to be carefully targeted to limit their effect on overall demand, and balanced by a reduction in demand elsewhere.

22. Second, the most sensible area to look for moderation of demand is among investors. While it is not for the Bank to make specific recommendations for changes to the tax system, the work undertaken in preparing this submission has highlighted a number of areas in which the taxation treatment in Australia is more favourable to investors than is the case in other countries. In particular, the following areas appear worthy of further study by the Productivity Commission:

- i. the ability to negatively gear an investment property when there is little prospect of the property being cash-flow positive for many years;
- ii. the benefit that investors receive by virtue of the fact that when property depreciation allowances are “clawed back” through the capital gains tax, the rate of tax is lower than the rate that applied when depreciation was allowed in the first place.
- iii. the general treatment of property depreciation, including the ability to claim depreciation on loss-making investments.

Any changes in these arrangements probably cannot be divorced from the general tax structure, including the level of marginal income tax rates faced by investors and the point in the income distribution at which they cut in. Any changes would also need to take into account how they would affect other asset classes.

As an additional point, we welcome initiatives by the Australian Tax Office to tighten enforcement of the existing tax law with respect to property investment, and would encourage a continuation of these initiatives.

23. Third, while a number of steps have been taken recently to bring the property investment seminar industry under closer regulation, a more consistent and unified regulatory framework is needed in this area.

24. Fourth, there should be some consideration given to evaluating how state stamp duty raises the barrier to home ownership by first-home buyers who, as a class, are most restricted by their capacity to overcome the “deposit gap”.

25. Fifth, while we do not believe supply deficiencies at a macro level are the main reason for the reduction in affordability for first-home buyers, there may well be possibilities for increasing the responsiveness of supply and speeding up the approval process.

Importantly, we do know the direction of the influence of increased supply – it will put downward pressure on prices in at least some areas of the housing market.

26. The body of this submission is set out in three parts. The first part presents the main facts concerning the trends in house prices, borrowing for housing, and affordability. The second part evaluates the possible explanations for the increases in house prices observed over recent years. The third part suggests areas that could be examined further as possible means of alleviating the current pressures on affordability for first-home buyers.

1. The Australian Housing Market: Prices, Ownership and Affordability

This chapter discusses the basic facts relating to housing prices, household indebtedness, first-home buyers and the ownership and composition of the housing stock. These facts provide the basis for the discussion in the following two chapters. The focus, wherever possible, is on those characteristics of the recent developments in Australia that are unusual by historical or international standards.¹ The main points are as follows:

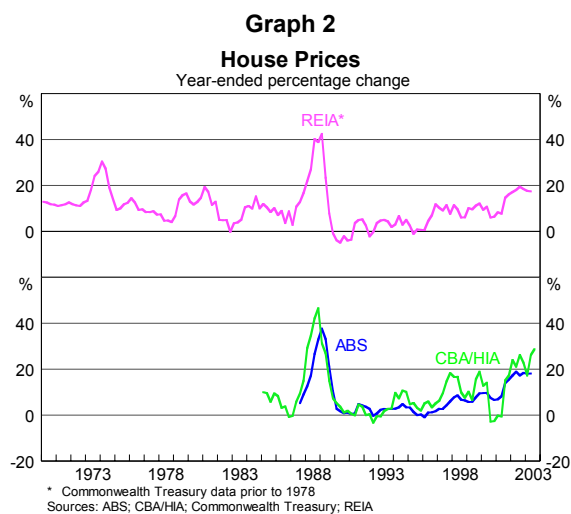
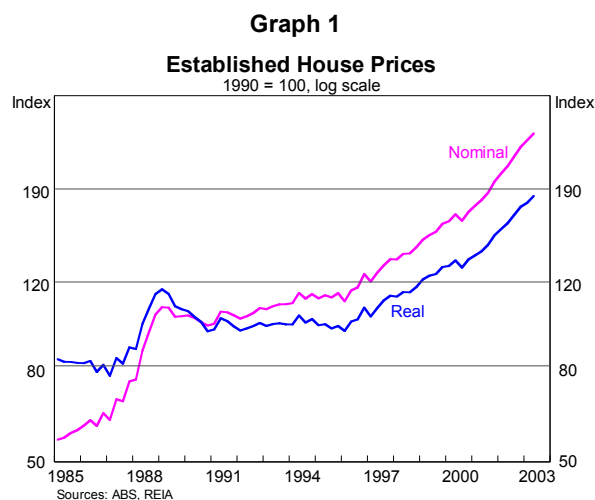
- The increase in housing prices since the mid 1990s has been unusually large, both by the standards of Australia's past and by comparison with experience abroad.
- Higher prices have been accompanied by a rapid increase in household indebtedness, driven by the growth of housing-related debt. The household debt-to-income ratio is now relatively high by international standards. This is not the case, however, for the ratio of debt to housing assets; although this ratio has risen, the extent of the rise has been held down by the cumulative increases in house prices.
- The current boom in house prices has been characterised by very strong demand by investors to purchase properties for rental purposes. This has seen borrowing by investors increase considerably faster than that by owner-occupiers and a significant increase in the share of households that own an investment property. The Australian experience in this respect has been quite different to that of other countries, where private investors have not played a comparable role in the market.
- In contrast to housing prices, rents have grown only modestly since the mid 1990s. As a result, gross rental yields have declined considerably, and are now well below historical and international norms.
- Australia has for many decades had a high owner-occupation rate. This has shown little net change over recent decades, although the owner-occupation rates for most age groups have fallen.
- The number of first-home buyers has declined over the past two years, largely explained by a surge in the number of first-home buyers in 2001.

¹ In preparing this submission, discussions were held with central banks and housing authorities in the United States, Canada, the United Kingdom and the Netherlands. The range of sources consulted is listed in the Appendix.

- Measures of affordability of home ownership have declined since the mid 1990s, with house price increases more than offsetting the impact of lower interest rates on affordability.
- The stock of apartments in Australia has grown more quickly than that of detached houses over recent years, though detached houses still form the bulk of the Australian housing stock. In all countries, detached houses tend to be relatively expensive.

1.1 Housing prices

The current focus on housing prices and affordability comes at a time when house prices in Australia have been rising rapidly over a prolonged period. In broad terms, the current upswing in house prices began in the mid 1990s, after a period of relative stability in the first half of the decade. Taking the March quarter of 1996 as a broadly representative starting point for the current upswing, the median house price has since increased at an average annual rate of 12 per cent, with prices of apartments increasing almost as quickly. In the latest two years, the trend has accelerated, so that the broad measures of house prices are currently showing annual rates of increase of close to 20 per cent.² As a result of this growth, the median house price is currently around 2.3 times that in early 1996, and 2.5 times that in early 1990 (Graph 1).³



² Measures of housing prices in Australia are published by the Australian Bureau of Statistics (ABS), the Real Estate Institute of Australia (REIA) and jointly by the Commonwealth Bank of Australia (CBA) and the Housing Industry Association (HIA). All three measures show broadly similar movements through time, although the CBA/HIA measure of established house prices has tended to increase more quickly than the other measures. In this submission, we use the REIA measure as, unlike the ABS measure, it is available in value terms and not just as an index. The REIA also publishes separate measures for houses and apartments, while the ABS publishes only a house price index. Unless otherwise indicated, house price data presented in the statistical material in this submission are for established detached houses.

³ All price indices are constructed from sales prices. The median selling price is less than the average selling price reflecting a relatively small number of very highly priced properties.

A period of strongly rising house prices is not in itself unprecedented. The housing market has shown pronounced cycles in the past, including strong upswings in the early and late 1970s and a particularly sharp increase in the late 1980s. These have been interspersed by periods of greater stability, and occasionally falls, in prices. The current rate of increase in house prices, though well above average, is less than the peak rates of increase reached in some previous cycles, particularly that in the late 1980s, when the annual increase peaked at around 40 per cent (Graph 2). What is unusual about the current upswing, however, is that it has continued over a more prolonged period than has been typical in the past, and has occurred at a time when the general inflation rate has been low. As a result of these characteristics, the cumulative increase in house prices in inflation-adjusted terms has been larger than those occurring in previous cycles. For example, there was a cumulative increase in real house prices of the order of 50 per cent in the late 1980s, while in the current episode the average real house price has almost doubled (Table 1).

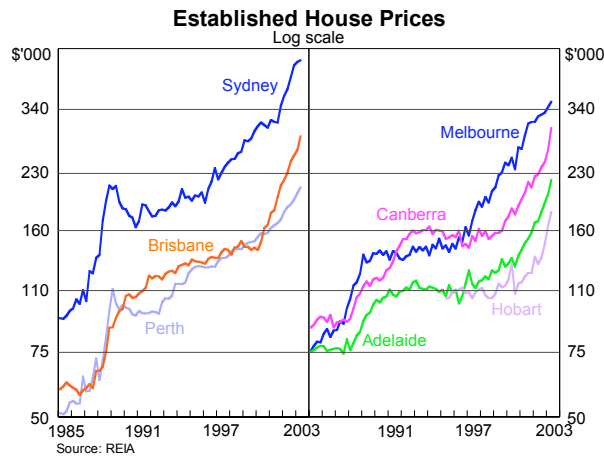
	Nominal		Real	
	From trough to:		From trough to:	
	March 1989	June 2003	March 1989	June 2003
Sydney	101.4	143.7	77.0	106.7
Melbourne	60.2	150.5	40.8	112.4
Brisbane	46.2	121.8	28.5	88.2
Adelaide	18.2	98.8	3.9	68.6
Canberra	25.4	98.5	10.2	68.3
Perth	89.9	65.2	66.8	40.1
Hobart	na	63.6	na	38.8
Darwin	na	28.0	na	8.5
Australia	73.6	128.2	52.6	93.6

Source: REIA

* Increases are measured from the time of the trough in the national real house price series (March 1987 and March 1996 respectively). The timing of the troughs in real house prices varies across individual cities.

Another feature of the current boom in house prices is its broad geographic spread. Initially, the strong upward pressure on house prices was confined to Sydney and Melbourne. Between 1996 and 2000, the median price increased in both cities by around 13 per cent per year, on average, while in the other capitals, increases averaged below 5 per cent. However, since early 2002, upward pressure on house prices has become much more widespread. Over the past year, for example, prices have increased by at least 20 per cent in Adelaide, Brisbane, Canberra and Hobart (Graph 3). Similar price increases have been recorded in a number of regional centres.

Graph 3

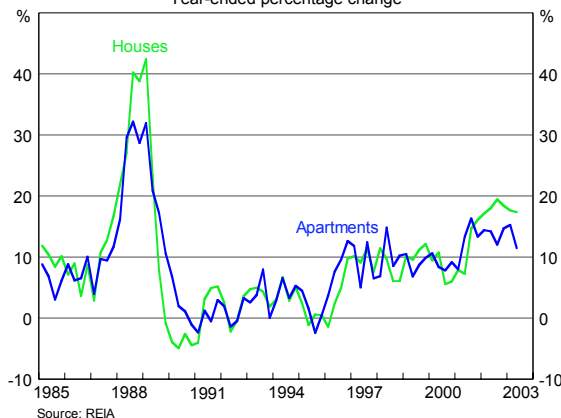


At an aggregate level, prices in the apartment market have tended to show similar trends to those in the market for detached houses (Graph 4). However, it is likely that the broad aggregates for apartment prices overstate the average rate of increase since, over time, they are affected by a significant shift in apartment turnover towards inner-city areas where prices are relatively high. In addition, it should be noted that, at any point in time, the broad aggregate indices can mask considerable divergences in conditions across different parts of the market. Over the past couple of years, for example, there has been increasing evidence of oversupply in parts of the apartment market, particularly in the inner areas of Melbourne and possibly Sydney, where prices in the June quarter were around 4 per cent below their peaks (Graph 5). However, there is no indication that this easing of price pressures has become more widespread, and the broad city-wide indices are continuing to show rapid rates of price increase both for apartments and for detached houses.

Graph 4

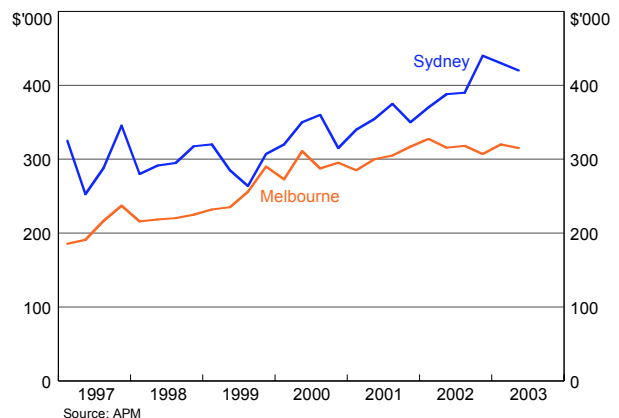
House and Apartment Prices

Year-ended percentage change



Graph 5

Inner City Apartment Prices

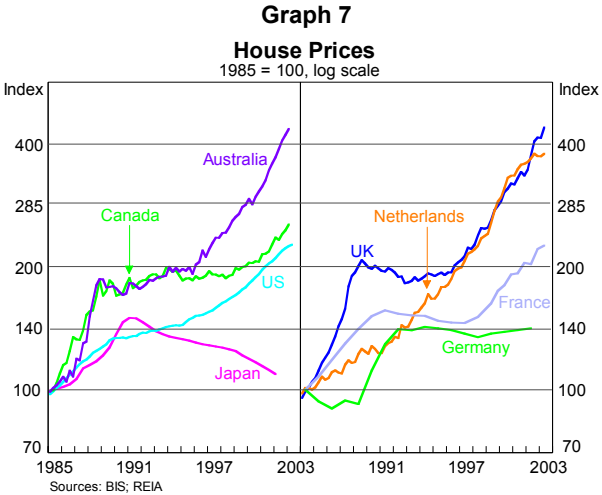
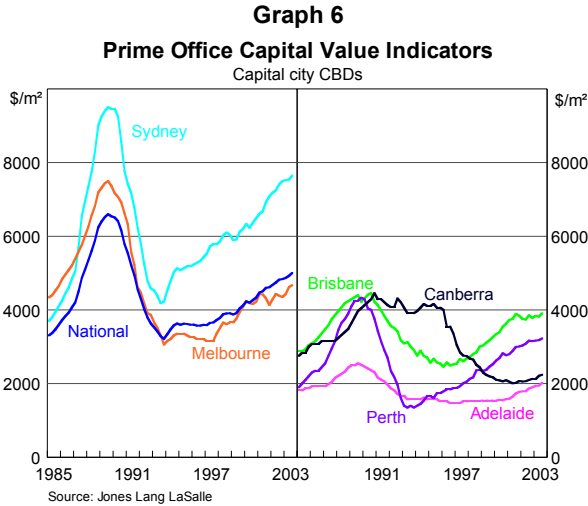


Increases in house prices can be notionally separated into two components representing the land (or location) value and the cost of constructing a house. As is usually the case, the increases in established house prices observed over recent years have been mainly attributable to the first of these components. Since 1996, the cost of building a standard

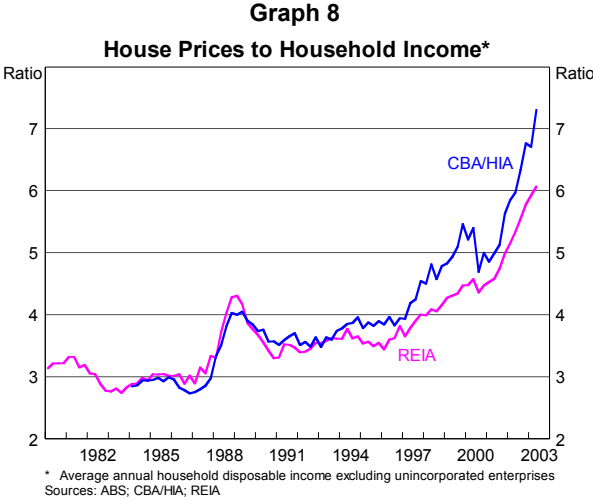
project home, for example, has increased at an average annual rate of 4.2 per cent. While higher than the general inflation rate, this rate of increase is around 8 percentage points lower than the average annual increase in the median price of established houses.

Unlike earlier episodes, the current upswing in house prices has not been associated with a broader boom encompassing the commercial property sector. In the early 1970s and late 1980s, when house prices rose quickly, so did prices of commercial property. Indeed, in the late 1980s, the rate of increase in commercial property prices far outstripped that in housing prices. In contrast, since the mid 1990s, prices of commercial office buildings have increased at an average annual rate of just over 4 per cent, considerably below the rate of increase in housing prices. The price indices for commercial office buildings remain below their late-1980s peaks in all capital cities, with the recent gains not yet having made up for the large fall in prices during the first half of the 1990s (Graph 6).

Across countries, movements in house prices have shown marked divergences over recent years (Graph 7). At the low end of the range are a number of countries where house prices have been flat or declining. In Japan, for example, prices at the national level have declined by around 30 per cent since their peak in 1991, and considerably more in the large cities. Prices have also fallen significantly in Hong Kong and Singapore in recent years. In Germany and Switzerland, prices are broadly unchanged from 1995 levels. At the other end of the range, a number of countries have experienced increases in house prices broadly similar to those in Australia. For example, in the United Kingdom and the Netherlands residential property prices have increased at an average annual rate of more than 10 per cent since 1995, although the rate of increase has recently moderated considerably in the Netherlands.



The rate of growth of house prices in Australia over recent years has significantly exceeded growth of household incomes, so that the ratio of house prices to incomes has shown a strong upward trend since the mid 1990s (Graph 8). This ratio has, in the past few years, risen to levels not previously seen in Australia. On the latest available REIA data, for the June quarter 2003, the median house price was equivalent to around 6 times the average annual household income, compared with a ratio of just over 4 times income at the peak of the late 1980s boom. Using the measure of prices based on transactions financed by the Commonwealth Bank, the increase is even larger. Some international comparisons of housing asset values relative to incomes are presented in Table 2.⁴ While it is difficult to ensure that these data are compiled on a fully comparable basis, the available evidence suggests that the ratio of house prices to incomes in Australia is now relatively high by international standards, whereas a decade ago it had been similar to that observed in a number of other countries.⁵



⁴ The table shows the aggregate value of housing assets owned by the household sector in each country, expressed as a ratio to aggregate household disposable income (including income of unincorporated enterprises). Strictly speaking, this is not a direct measure of the ratio of house prices to incomes: while differences between these ratios across countries will primarily reflect relative housing prices, they will also reflect differences in the proportion of the housing stock owned by households, as opposed to public and institutional ownership.

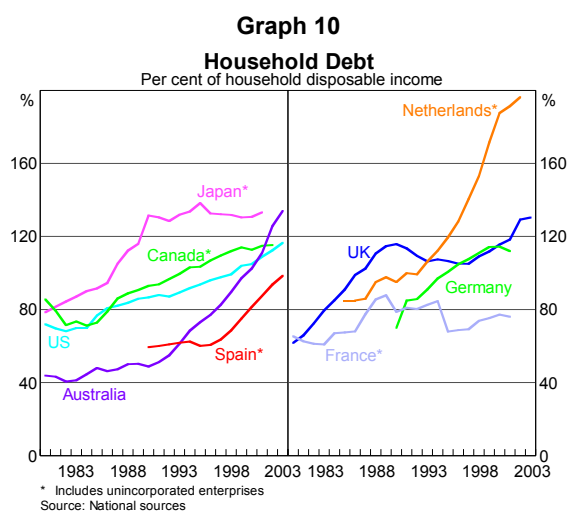
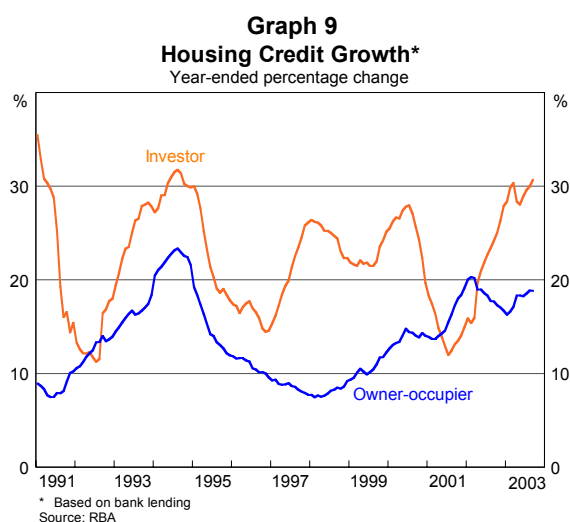
⁵ For further discussion of this evidence, see Ellis L and D Andrews (2001), "City Sizes, Housing Costs, and Wealth", Reserve Bank of Australia Research Discussion Paper 2001-08.

	1980	1985	1990	1995	2000	2002
Australia	218	221	259	283	351	462
Canada ^(b)	-	234	239	259	264	267 ^(c)
Japan ^(b)	380	397	680	468	419	408 ^(c)
Netherlands	204	160	180	234	392	395
New Zealand	162	228	251	311	319	352
United Kingdom	91	148	245	213	331	403
United States	162	168	169	160	174	188

(a) Owned by household sector. Household income includes unincorporated enterprises.
(b) Figures refer to non-financial assets, which include consumer durables as well as dwellings.
(c) 2002 data refer to 2001.
Sources: ABS; Bank of England; Netherlands Bureau for Economic Policy Analysis; Datastream; OECD; RBA; RBNZ

1.2 Household borrowing

The rapid increase in housing prices in Australia has been accompanied by strong growth in borrowing by the household sector. Since the beginning of 1996, household debt has increased at an average annual rate of 14½ per cent, and has accelerated more recently to a pace of around 20 per cent over the past year. Most of this increase has been in loans for the purchase of housing. This component of household debt now accounts for 84 per cent of the total debt of the household sector, up by around 15 percentage points since 1990. As discussed below, housing-related debt can in turn be separated into borrowing for owner-occupation and borrowing for investor housing. While borrowing for owner-occupation is still the larger of these components, the investor component has been growing much more quickly over recent years (Graph 9).



The growth in household debt in Australia has been unusually fast by international standards. Among other advanced economies, only the Netherlands and Spain have recorded comparably rapid credit growth in the period since 1995. In other advanced countries, credit

growth rates of the order of 5 to 8 per cent per year have been typical over this period (Table 3).

	1996 to latest ^(a)	Year to latest
Australia	14.8	20.6
United States	8.4	11.0
Japan	2.3	3.7
Germany	5.2	2.8
France	5.2	6.4
United Kingdom	7.4	9.1
Canada	6.6	8.1
Spain	17.0	13.3
New Zealand	9.8	13.3
Sweden	7.5	9.6
Netherlands	13.5	3.5
Finland	7.6	11.8

(a) Average annual growth
Sources: IMF; national sources; RBA

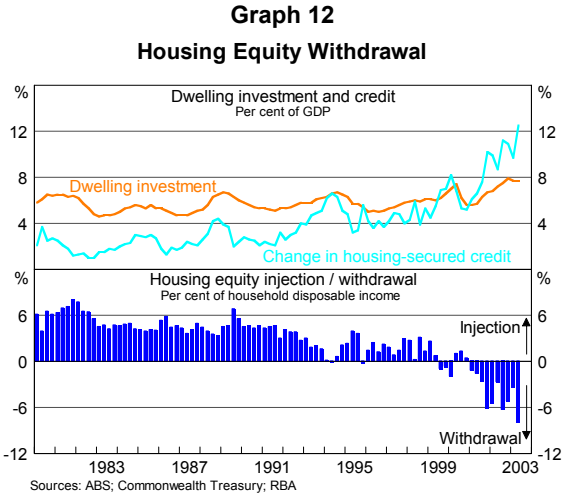
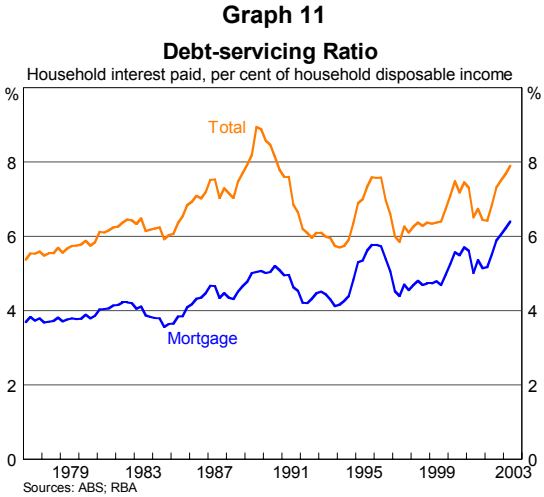
The rapid growth of household debt in Australia has resulted in a strong upward trend in the ratio of debt to income. In the 1980s and early 1990s, this ratio was low by international standards but, after a decade of significantly stronger-than-average debt accumulation, it is now at the top end of the range seen in most other countries (Graph 10). In the few countries where the ratio is significantly higher, particularly the Netherlands, this can be largely explained by tax arrangements, in the form of tax-deductibility of home mortgage interest payments for owner-occupiers, that discourage the repayment of that type of housing debt. As a result of such arrangements, households in these countries tend to use funds that would otherwise have been used to repay a housing loan to build up their financial assets. In contrast, in Australia, the tax system creates an incentive for households to repay owner-occupier housing loans quickly (this same incentive does not apply to investor loans).

The upward trend in the debt-to-income ratio has meant that the debt-servicing ratio – the ratio of interest payments to disposable income – has also trended upward over recent years (Graph 11). Mortgage interest costs now represent 6½ per cent of aggregate household disposable income, a level that exceeds its peak of around 5¾ per cent in the 1990s and is still increasing as mortgage debt continues to rise more quickly than incomes.⁶ The total interest costs of the household sector (ie including interest on other forms of household borrowing) now stand close to 8 per cent of household income. This ratio is still about a percentage point below the peak reached at the end of the 1980s boom, a point when

⁶ Repayment of principal is estimated to amount to a further 2½ per cent of income.

interest rates were at much higher levels than they are at present and when a greater proportion of household debt was in higher-cost forms of personal loans rather than mortgages. Nonetheless, on current trends, the debt-servicing ratio will continue to rise. For example, assuming a continuation of the current rates of growth in household debt and incomes, the overall debt-servicing ratio would exceed its previous peak sometime in 2004.

These measures of the debt-servicing ratio represent averages across all households, many of whom do not have a mortgage. Hence, the debt-servicing ratios for the subset of households that have a mortgage are considerably higher. Around 30 per cent of Australian households have a housing loan, a figure which has been broadly unchanged for the past two decades. For these households, the total servicing payment (interest plus required payment of principal) averages 20 per cent of disposable income. Again, there is considerable variation within this group. Among households with a mortgage, it is the relatively young households, those with lower than average incomes and, more generally, those with recently acquired mortgages, that tend to have relatively high ratios of interest payments to incomes. Given the relatively constant proportion of households with a mortgage, the rise in the aggregate debt-to-income ratio is accounted for by an increase in the average debt level of those households with a mortgage. Much of this additional debt appears to have been taken on by mid-life households with relatively high incomes.⁷

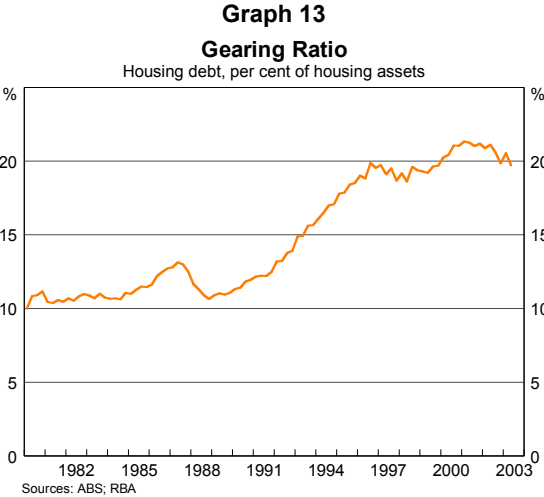


A consequence of rising house prices and the associated growth of debt has been that the increase in borrowing secured against housing has exceeded net new spending on housing assets. This implies that households, in aggregate, have been drawing on their accumulated equity in the housing stock to release funds for other purposes. This housing equity withdrawal has amounted to an average of around 4½ per cent of household disposable

⁷ For more details, see Ellis L, J Lawson and L Roberts-Thomson (2003), "Housing Leverage in Australia", Reserve Bank of Australia Research Discussion Paper 2003-09.

income since mid 2001; prior to this, the usual pattern was for the household sector to inject equity into the housing stock (Graph 12).⁸ The shift towards equity withdrawal over the past few years has been facilitated by the combination of rising house prices, which have increased the collateral available to the household sector, and the development of new lending products, such as home-equity loans and loans with redraw facilities, which have enabled households to borrow more easily against the equity in their homes (see Chapter 2).

The increase in housing-related debt has also meant an increase in the average housing gearing ratio – the ratio of housing debt to the value of housing assets. This ratio has approximately doubled since the 1980s, to be currently around 20 per cent (Graph 13), though it remains relatively low by international standards. Much of the increase in gearing in Australia occurred in the early to mid 1990s. In more recent years, although debt has been growing rapidly, the gearing ratio has been relatively constant, due to the similarly rapid increase in house prices. Obviously many individual households – those that have only recently acquired mortgages – would have much higher gearing than the average.



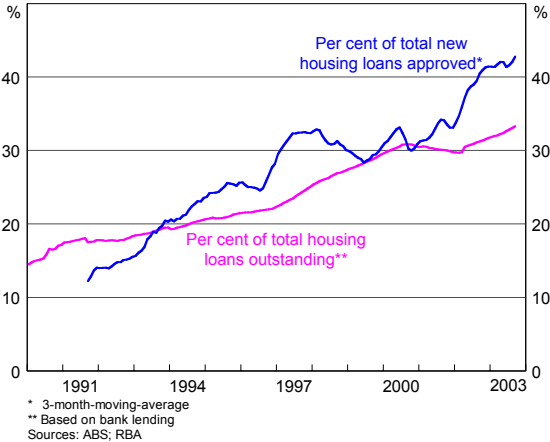
1.3 Investors in the housing market

Perhaps the most important distinguishing feature of the current housing price boom has been the very strong demand by household investors for the purchase of residential properties to rent. The extent of this demand is unprecedented, both in terms of previous experience in Australia and experience overseas. The prominent role of investors in the Australian housing market can be seen both in the high and rising share of housing finance going to investors, and in the relatively high proportion of households in Australia owning rental properties.

⁸ See Reserve Bank of Australia *Bulletin*, “Housing Equity Withdrawal”, February 2003, pp 50–54.

Since 1996, the value of investor housing loans outstanding has grown at an average annual rate of 22 per cent, and the pace has accelerated in more recent years to be currently around 33 per cent. Investor loans now account for around one-third of banks' outstanding housing loans, up from around 15 per cent at the beginning of the 1990s (Graph 14). Investors account for an even larger share of new loans approved. Since mid 2002, around 40 cents of every dollar of new housing loans approved by financial institutions has been for investment properties. The high proportion of housing finance accounted for by investors in the Australian housing market stands out as quite different from the experience of other countries. In most countries, the percentage of housing loans accounted for by investors is estimated to be only in single figures. In the United Kingdom, for example, gross lending for the "buy-to-let" market rose to a peak of around 6½ per cent of gross mortgage lending over the first half of 2003. Comparable data for other countries are difficult to obtain, partly reflecting the fact that, in these countries, individual investors play only a small role in the overall rental market, and hence their activities are not systematically recorded by statistical agencies as they are in Australia. Notwithstanding the lack of official figures, financial and housing authorities in a range of countries report that the role of household investors in their housing markets is relatively minor.

Graph 14
Investor Housing Loans

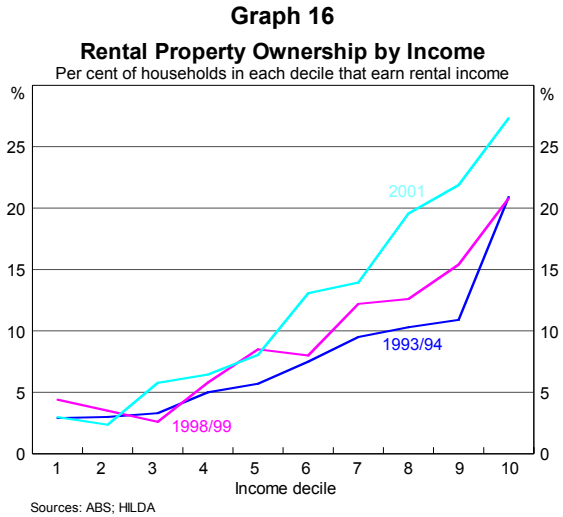
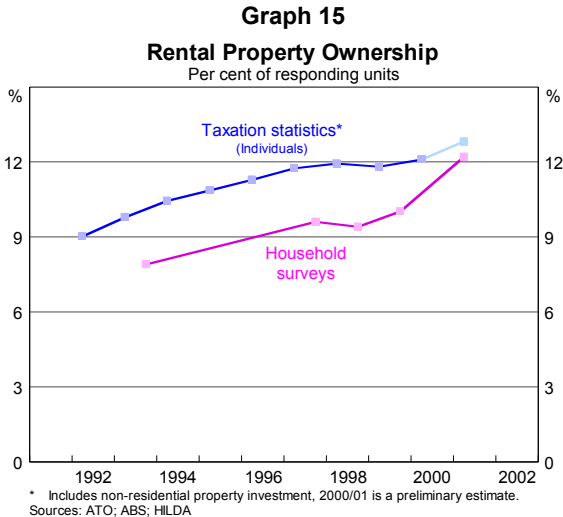


The strong investor demand for residential properties has seen the number of Australian households owning an investment property increase significantly since the early 1990s. Surveys suggest that the share of households with an investment property has risen from around 8 per cent in the early 1990s to around 12 per cent in 2001 (Graph 15).⁹ Ownership rates appear to have risen for almost all income groups, although the increases have been largest for households in the upper part of the income distribution (Graph 16). Similarly,

⁹ The data for the early 1990s are from the 1993/94 Household Expenditure Survey, while the more recent data are from the 2001 HILDA Survey.

according to the Australian Taxation Office (ATO), there has been a significant rise in the proportion of taxpayers reporting rental income. In the 2000/01 financial year, around 13 per cent of taxpayers, or 1.3 million individuals, reported earning rental income, compared with a figure of around 9 per cent in the early 1990s.

The proportion of Australian households owning an investment property is considerably higher than that in most other countries. In the United States, for example, taxation data indicate that around 6½ per cent of individuals earn rental income, and both tax and survey data indicate that this proportion has been falling over time.¹⁰ In Canada, ownership rates appear to be broadly similar to those in the United States. In the United Kingdom, less than 2 per cent of households own a rental property, although the rate of ownership has been increasing recently.¹¹ In these and other countries, a larger proportion of the rental stock is typically owned by institutions, government agencies and charities. In part, the low rate of individual ownership in other countries reflects the history of rent controls and other rigidities in the rental market.



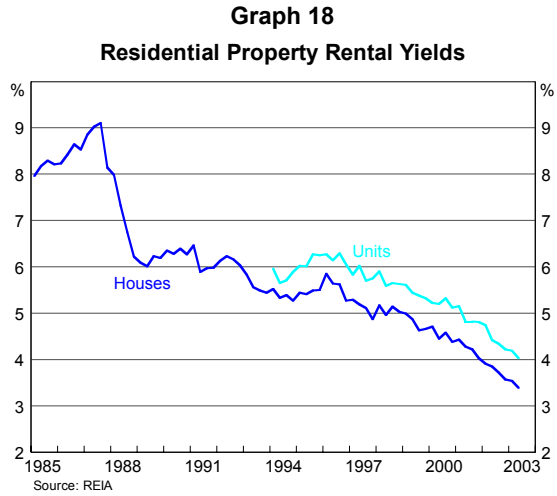
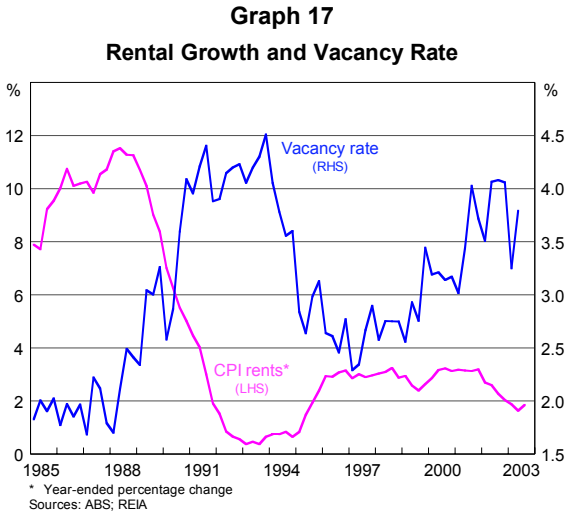
1.4 Rents and vacancy rates

In contrast to the large gains in housing prices, rents have increased only modestly over recent years, and the rate of increase has recently been declining. Since the March quarter of 1996, the Consumer Price Index measure of rents has increased at an average annual rate of 2.8 per cent, only slightly faster than the overall rate of inflation (Graph 17). Over the past year, this measure has increased by 1.9 per cent. An alternative measure of rents constructed from city-based data published by the REIA shows slightly faster average

¹⁰ The 2000 Survey of Income and Program Participation gives an alternative estimate of 5 per cent for households rather than taxpayers.

¹¹ This estimate is from the British Household Panel Survey 2000.

growth, but broadly in line with the growth in average household disposable income over this period.



As with housing prices, growth in rents was strongest in Sydney and Melbourne over much of the second half of the 1990s, with vacancy rates having been at relatively low levels in the middle part of the decade. More recently, however, rents have been subdued in both cities, and under downward pressure in some localities, reflecting higher vacancy rates as the increased supply of apartments comes on stream. In contrast, rents have been increasing more quickly in Canberra, Brisbane and Adelaide, with low vacancy rates in these cities still indicating a relatively tight rental market.

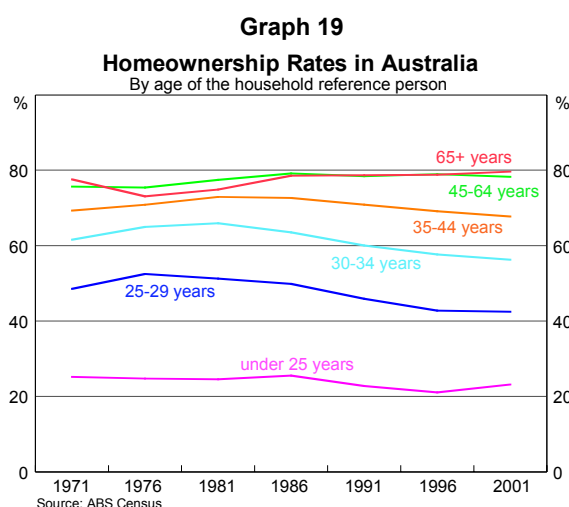
The combination of a rapid increase in housing prices and low increases in rents has meant that average rental yields have fallen to very low levels (Graph 18). In the mid 1980s, it was not uncommon for gross rental yields to exceed 8 per cent, with rents being under strong upward pressure due to very low vacancy rates. Rental yields began to fall during the housing boom of the late 1980s and have continued their downward trend since. Currently, gross rental yields are typically around 3–3½ per cent for houses and a little higher for apartments. After taking into account costs such as council rates, strata levies, management fees, repairs and maintenance, net rental yields are at least a percentage point lower.

Rental yields in Australia are very low by international standards. In the United Kingdom the average gross rental yield is currently estimated to be around 7½ per cent, down from around 9½ per cent at the start of 2002.¹² Rental yields in the United States tend to be around the same level as in the United Kingdom, while in Canada, it is not uncommon for rental yields to be as high as 12 per cent.

¹² This estimate is from the Paragon Mortgages Buy-to-Let Index.

1.5 Owner-occupation rates

Owner-occupation rates in Australia have traditionally been high by international standards, remaining relatively stable over the past few decades at around 70 per cent. Even so, ownership rates have fallen for most age groups, with the falls being most noticeable for younger households. In particular, ownership rates for households in the 25–29 and 30–34 year age groups have declined by a little less than 10 percentage points since the early 1980s. In contrast, ownership rates for households in the 45–65 year age group have changed little in net terms over this period. The fact that the overall ownership rate has remained relatively steady, while the rates for most age groups have declined, is explained by an increase in the share of older households as the population ages, with these households having higher ownership rates (Graph 19).

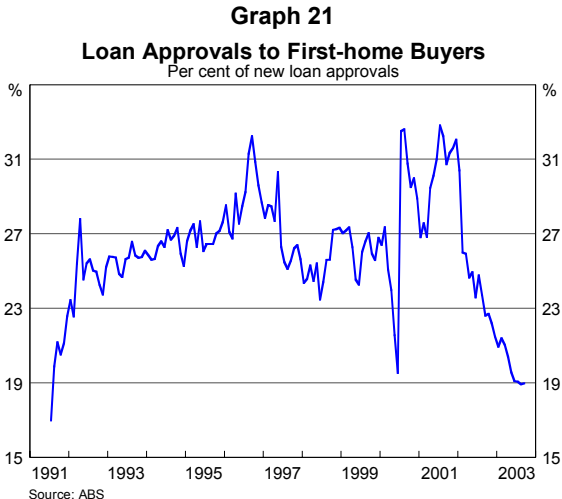
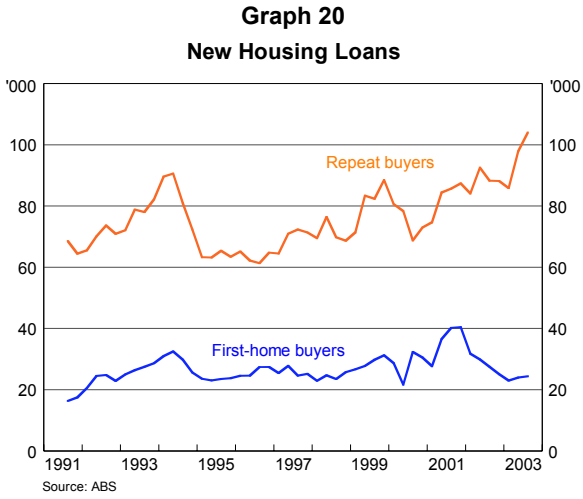


The fall in the ownership rates for younger age groups partly reflects an increase in the number of single-person households – as the average age of marriage has increased and the number of university students has risen – and a rise in the number of single-parent households. The ownership rate for couples with children has remained broadly unchanged since the early 1980s, at around 80 per cent.

1.6 First-home buyers

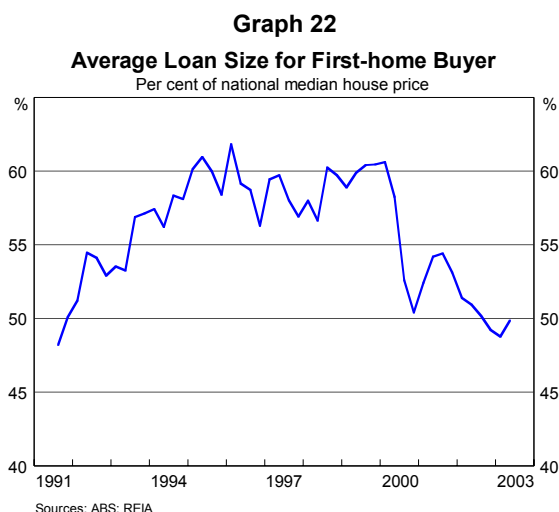
According to data on loan approvals, there have been around 110,000 first-home buyers purchasing a house with debt, on average, each year since the mid 1990s. The total number of first-home buyers (including those who did not borrow) peaked in 2001 at 187,000 following the introduction of the First Home Owner Grant (FHOG) (Graph 20). This peak partly reflects delays in purchasing by some households until after the FHOG was available, as well as the bringing forward of purchases made possible by the grant. The introduction of the Commonwealth Additional Grant (CAG), which operated between March 2001 and June 2002 would also have contributed to the bringing forward of some first homeowner

purchases into the qualifying period. At a quarterly rate, the number of first-home buyers peaked at around 55,000 in the December quarter of 2001. More recently the unwinding of these effects has contributed to a decline in the number of first-home buyers to quarterly levels of around 30,000, or a little below the medium-term average. This decline has occurred at a time when financing for repeat buyers has been growing very rapidly and, as a result, the share of first-home buyers in total finance approvals for owner-occupied housing (excluding refinancing) has fallen sharply (Graph 21).



There are no comprehensive time-series data on the prices paid by first-home buyers, although data are available on the average size of the loans they take out to fund the purchase. Assuming that the ratio of the loan size to the price paid has remained unchanged, these data suggest that the average price paid by first-home buyers has increased by somewhat less than the median price of all houses over recent years (Graph 22). Since the March quarter 1996, for example, the average loan size of first-home buyers has risen by 100 per cent while, as discussed above, the median house price has risen by 130 per cent. Thus, first-home buyers are buying homes that are further below the median price of all homes than was formerly the case.

The data on the average size of loans taken out by first-home buyers are broadly consistent with information on prices paid for properties purchased under the FHOG scheme. Data on FHOGs paid also confirm that the average price paid by first-home buyers is lower than the median metropolitan house price. This partly reflects the inclusion of apartments in the FHOG data, as well as the fact that purchases by first-home buyers tend to be in relatively less expensive areas.



1.7 Affordability

There is no single universally applicable measure of affordability.

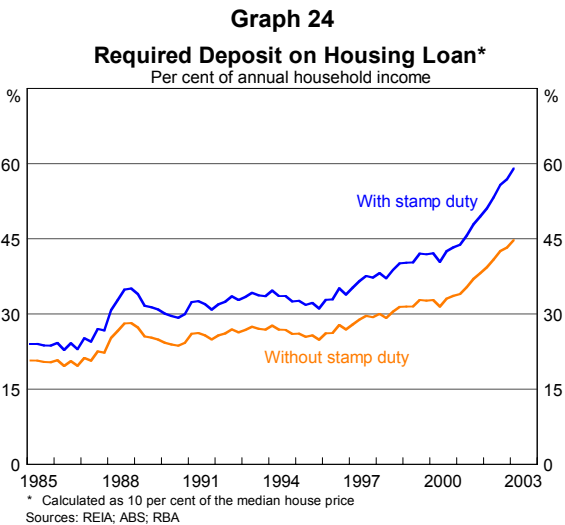
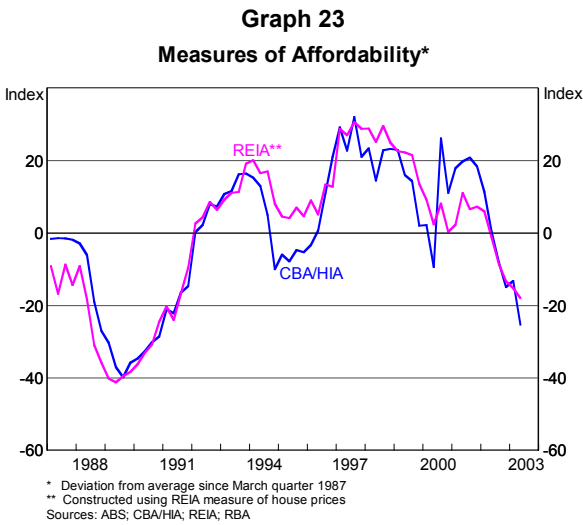
The most commonly cited measure is the ratio of average household income to the income required to meet debt repayments on a typical house. As the cost of debt finance, or the size of loans, falls, the denominator in this ratio also falls, and housing is said to be more affordable.

There are a number of measures of this type. A prominent one is that jointly produced by the Commonwealth Bank of Australia (CBA) and the Housing Industry Association (HIA). It is constructed to measure the affordability of the median-priced established dwelling purchased by first-home buyers.¹³ Similar measures can be constructed using other house prices series.

These measures show that affordability has declined over recent years as housing prices have increased (Graph 23). Comparing the latest period with the early 1990s, the level of housing interest rates is now significantly lower, but the impact of this on affordability has been more than offset by the cumulative increase in house prices relative to incomes. The current level of affordability is still above the low point reached at the end of the 1980s boom, a period when interest rates were exceptionally high and the ratio of house prices to incomes was also at a peak. The affordability measure produced by CBA/HIA has fallen by more than other measures over recent years, reflecting the faster rate of increase in the CBA measure of house prices.

¹³ Until the December quarter 1987, this measure uses an estimate of the median dwelling price based on loans taken out with the CBA by first-home buyers. From 1988, with separate information on loans to first-home buyers no longer available, movements in the series are based on movements in the median price paid by all home buyers who financed with CBA.

The fact that the average price of houses purchased by first-home buyers has increased less quickly than the average price of all houses suggests that an affordability index for first-home buyers would not have declined as much as the indices in Graph 23. There are two interpretations of this result. The first is that, as prices have risen, first-home buyers have had to purchase properties that are less expensive, relative to the median, than was the case in the past. This could be occurring through the purchase of apartments, rather than houses, or the purchase of houses in less desirable areas than was previously the case. The second is that, first-home buyers are still purchasing the type of properties that they always have, but that the prices of these properties have not increased as quickly as overall prices. Unfortunately, the data available to the Bank does not allow us to distinguish between these two explanations.



An alternative measure of affordability is based on the size of the deposit required to purchase a given home; in particular the ratio of the average required deposit to household income. Assuming a fixed loan-to-valuation ratio, this measure is directly determined by the ratio of house prices to income. As discussed above, this ratio has increased considerably over recent years and, as a result, households now need to save a larger amount relative to their income than was previously the case before they can purchase a home. For example, in 1990, a 10 per cent deposit on the median-priced house was equivalent to around 25 per cent of average annual household income (Graph 24). Today, the figure is around 45 per cent.¹⁴ The increase is even more significant if stamp duty is taken into account, reflecting the fact that the average rate of stamp duty has risen as nominal prices have increased. In 1990, stamp duty (calculated at NSW rates) on the median-priced house in Australia was equivalent to 6 per cent of annual income. Today, the figure is around 14 per cent. For many

¹⁴ Household income used in this calculation is based on the national accounts measure but excludes imputed income on owner-occupied dwellings.

people who may be able to meet the ongoing repayment burden, these upfront costs have become a significant constraint on their ability to purchase a home.

For first-home buyers the up-front deposit constraint has been eased by the First Home Owner Grant. Taking account of this grant reduces the savings required to fund a deposit on the median-priced house from around 45 per cent of average household income to around 35 per cent. Given that many first-home buyers purchase houses with prices lower than the median, the FHOG has made a significant contribution to easing the deposit constraint.

1.8 The housing stock

The Australian housing stock has two particularly distinguishing characteristics relative to that in other countries. The first is the high proportion of detached houses and the second is the high proportion of the housing stock located in major cities. Overall, the quality of the housing stock appears to be broadly comparable with that in a number of major industrialised countries. Although the average size of dwellings is larger than in some European countries, this partly reflects the larger average size of households in Australia.

Around three-quarters of the housing stock in Australia is accounted for by detached houses. The comparable figure for the United States is 60 per cent and for the United Kingdom it is 25 per cent (Table 4).¹⁵ While data on the average amount of land used by each dwelling are not available, the above figures suggest that, on average, dwellings in Australia take up more land than is typically the case elsewhere. The large geographical size of Australian cities, relative to their populations, provides further support for this conclusion.

Housing in Australia not only appears to take up more land, but is more heavily concentrated in major cities than is the case elsewhere. Fifty-five per cent of the urban population of Australia live in either Sydney or Melbourne, the two largest cities. This level of concentration is well above that in most countries. A further 30 per cent live in the other capital cities and unlike most other countries, Australia has no middle-sized cities, defined according to the UN as having between 500,000 and 1 million inhabitants. Since detached houses, and houses in large cities, tend to have relatively high prices in all countries, the preponderance of these characteristics in the Australian housing stock would provide one reason why the level of housing prices in Australia would tend to be higher than in other countries. However, this would not explain the continuing high rate of increase in Australian housing prices over recent years.

¹⁵ For further details see Ellis L and D Andrews (2001), "City Sizes, Housing Costs, and Wealth", Reserve Bank of Australia Research Discussion Paper 2001-08.

Table 4: Housing Stock and Population Concentration^(a)

	Houses	Detached houses	Share of urban population in two largest cities	Share of urban population in medium-sized cities
	Per cent of stock			
Australia	85.6	76.5	54.2	0
Canada	66.4	55.9	42.7	20.4
France	56.2	na	48.8	13.0
Germany ^(b)	45.6	31.0	20.1	21.8
Italy	na	na	29.3	16.8
Japan	na	59.2	19.1	8.4
New Zealand ^(c)	83.0	73.0	66.0	0
Sweden	45.7	na	61.1	32.8
United Kingdom	80.7 ^(d)	25.6	17.8	4.1
United States	66.7	60.6	16.7	9.7

(a) The United Nations defines urban population as residents of cities with populations 100 000 or greater, and a medium-sized city as one with a population between 500 000 and 1 million.

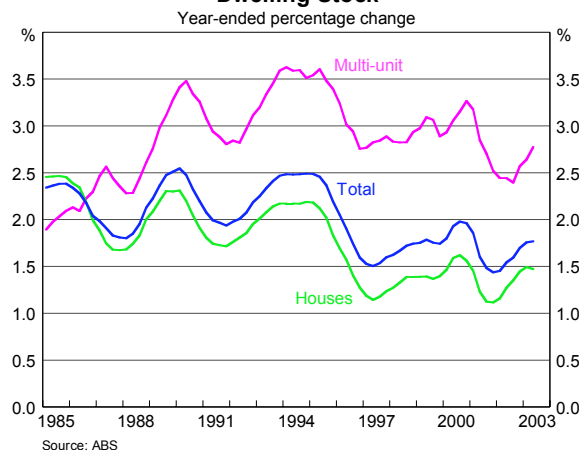
(b) Housing stock data for West Germany only.

(c) Detached house data refer to Auckland.

(d) England only.

While Australians live mainly in detached houses, over recent years the stock of housing in multi-unit developments has grown at more than twice the rate of the stock of detached houses (Graph 25). This difference in growth rates is particularly noticeable in Sydney where, since 1996, almost two-thirds of new housing construction has been in medium or high-density developments. If this were to continue, as is widely expected, then the composition of the housing stock will change considerably over time. For example, within 20 years, the share of multi-unit dwellings in Sydney would increase from its current share of around 37 per cent, to above 45 per cent. Similar trends are evident in other cities, although the shares of multi-unit dwellings are considerably lower.

Graph 25
Dwelling Stock



2. Factors Behind the Recent Rise in House Prices

Explaining why house prices have risen is more involved than simply stating that demand exceeded supply. The market for dwellings has some important and unique features which are key to understanding why prices have behaved in a particular way.

First, the rate at which new houses are built is very small relative to the stock of existing houses; each year's supply of new houses is less than 2 per cent of the existing stock. The housing market is primarily an asset market. Most of the transactions in the housing market are associated with buying and selling existing dwellings. As a result, house prices could rise or fall irrespective of what was happening to the supply of new houses. For example, it is possible to conceive of a totally static population where the underlying demand for additional dwellings each year is zero, but where prices will still rise rapidly if people's purchasing power is substantially increased.¹⁶

Second, unlike many goods, the supply of housing is far from homogeneous. Location, in particular, matters a lot in real estate. A consequence of this is that housing on the urban fringe is generally not seen by homebuyers as a very close substitute for housing in established preferred areas, although at the margin, infrastructure development can improve substitutability. The importance of location means that, in most circumstances, an increase in supply in outer areas is likely to have only a relatively small effect on prices for houses in preferred locations, including those close to the city.

Third, and perhaps most importantly, homebuyers' purchasing power is mainly influenced by their access to credit. More than in any other market, the vast majority of purchases in the housing market are financed by debt. So the supply of and demand for credit become major determinants of house prices.

This chapter discusses three possible explanations for the increases in house prices and changes in affordability over recent years. First, it looks at changes in the structural demand for housing arising from population growth, immigration and household formation, and whether the supply of new houses has kept pace with demand. Second, it examines the impact of stamp duty and the First Home Owner Grant on prices and affordability. And third it focuses on changes in the supply and demand for credit, by both owner-occupiers and investors in rental property, and their implications for the housing market. It concludes that it is the third set of factors, namely changes in the supply of credit and the capacity and

¹⁶ One other assumption is necessary here: that there is a proportion of people who would like to have a better home, or a better-located home, than the one they can currently afford. It would be hard to believe this assumption would not be met.

propensity of people to borrow, that provides the main explanation for the sharp rise in house prices over recent years.

2.1 Structural demand and supply

One possible reason for the rapid increase in house prices is that underlying demand has risen and supply has not caught up. In order to test whether this is the case, it is customary to establish the underlying demand for new dwellings each year on the basis of the growth in population or, if possible, the growth in household formation.

When this is done for Australia, it can quickly be seen that over the past decade the population has not grown any more rapidly than it has at other times in the post-war era (Table 5). In fact, while growth in population has picked up a little recently, the current pace of growth is well below rates experienced in the 1950s and 1960s. Given that overall population growth is not faster than in the past, it is hard to claim that one component of population growth, namely immigration, is a cause of rising house prices, even though the rate of immigration is now higher than five years ago.

Table 5: Population and Household Growth
Average annual percentage rate

	1950s	1960s	1970s	1980s	1990s	2000–2002
Natural increase ^(a)	1.4	1.2	1.0	0.8	0.7	0.6
Net Immigration ^(a)	1.0	0.8	0.5	0.7	0.4	0.7
Population	2.4	2.0	1.5	1.5	1.2	1.3
Households ^(b)	3.7	2.8	2.4	2.0	1.8	1.9

(a) Percentage point contribution to growth.
 (b) Annual growth between closest census dates; 1950s is for 1947 to 1961. Figure for latest period is an ABS estimate for 2000–2001.

Source: ABS

Many social factors need to be taken into account in translating population growth to growth in the number of households, which is the key driver of demand for an increased number of dwellings. The increase in the number of divorces, the decline in the number of children per household and the ageing of the population all mean that the average size of households has declined. This has been partly offset by the tendency of single adults to either remain in the family home or to share accommodation. The difficulty in quantifying these effects means that estimates of household formation are necessarily less accurate than estimates of population growth. Nevertheless, the various estimates suggest that the pace of growth in the number of households is below its historical average, although in the past couple of years it appears to have picked up slightly in line with the pick-up in population growth.

Private sector estimates suggest that over the second half of the 1990s, underlying demand was running at about 140,000 new homes per year. While the number of homes built varied

considerably from year to year over this period, the average number was in line with this estimate of underlying demand. More recently, estimates of underlying demand for new dwellings have picked up to around 160,000 per year, consistent with the pick-up in household formation. The number of homes built has also risen, with around 155,000 having been completed over the past year, and a considerable number due to be completed over coming months. Our overall assessment, based on these numbers, is that, at least at the national level, there is little evidence to suggest that aggregate supply has failed to keep up with the growth in underlying demand for new housing. Rising vacancy rates for rental accommodation provide further evidence for this assessment.

Notwithstanding this national picture, there may well be shortages in some geographical areas and over-supply in others. Similarly, there may be shortages of some types of housing and excess supply in others. In particular, there is now clear evidence that there has been an oversupply in inner-city apartments in some areas, and anecdotal evidence suggests there may have been a land-induced shortage of supply of detached houses in other areas. The cost of providing services for newly-developed land has also risen, which has tended to increase the price of houses in those areas.

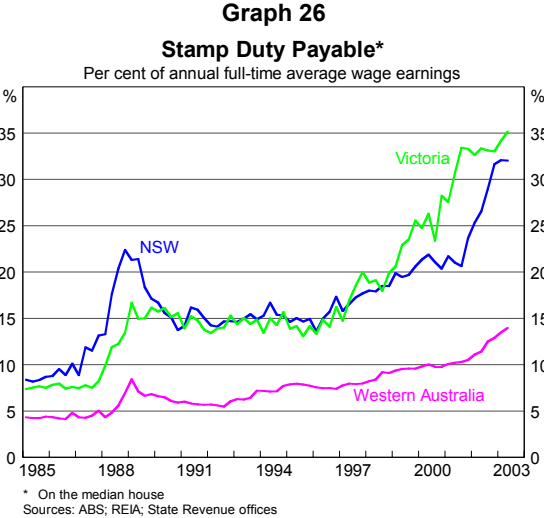
Since we at the Reserve Bank do not have the expertise to evaluate the micro data, we will confine ourselves to the aggregate. A number of participants in the building and property industries have argued that a lack of supply in some locations is a primary reason for higher house prices. While supply issues may be a factor in some markets and help explain variation in price movements across cities, we see no evidence to suggest that, overall, a shortage of supply of new houses relative to the underlying demand is the main explanation for the widespread rise in house prices over recent years. That said, there may well be things that could be done to make supply of new dwellings more responsive to changes in demand in some areas.

2.2 Stamp duty and grants to first-home buyers

As discussed in the previous chapter, a major factor limiting the ability of many potential first-home buyers to enter the market is the difficulty of finding sufficient funds to cover the up-front costs. The largest of these costs (excluding the deposit on the loan) is stamp duty, which amounts to around \$5,000 on the average house purchased by first-home buyers, and considerably more in the larger cities. As house prices have risen over recent years, the barrier to home ownership posed by stamp duty has increased considerably. This reflects two features of the current arrangements.

The first is the fact that state governments have not materially adjusted stamp-duty thresholds as house prices have risen. As a result, the average rate of stamp duty payable

on the median-priced house has increased substantially, both relative to house prices and average incomes. For example, in 1995 the stamp duty payable on the median-priced house in Sydney was equivalent to 15 per cent of annual income of a full-time wage earner in NSW. Today, the figure is more than 30 per cent. In Victoria, the increase has been even more pronounced (Graph 26).



The second is that the stamp duty concessions given to first-home buyers have not kept pace with the increase in prices. In Victoria, for example, first-home buyers receive a concession (subject to eligibility requirements) if the purchase price is less than \$200,000, while in Queensland the threshold is \$160,000. Some years ago, the relevant thresholds were sufficiently high relative to median house prices to be a benefit to many first-home buyers. However, today they are below the estimated average price paid by first-home buyers.¹⁷ This is particularly the case in the larger cities.

Overall, while stamp duty has made it more difficult for first-home buyers to afford the up-front costs associated with home ownership, it is not the source of high house prices. Indeed, stamp duty has probably had a mildly depressing effect on prices as it reduces the amount that a household with a given borrowing capacity can bid for a house. This effect is, however, likely to be quite small.

It is also sometimes claimed that the First Home Owner Grant (FHOG) and the Commonwealth Additional Grant (CAG) have contributed to a deterioration in affordability by pushing up house prices. Under the FHOG, which was introduced in July 2000, first-home buyers are paid \$7,000 as an offset to the introduction of the GST. A further \$7,000 was paid under the CAG to first-home buyers that entered into a contract to build a new dwelling

¹⁷ The estimates are calculated using the average loan size of first-home buyers, and assuming that the purchaser borrows 80 per cent of the value of the property.

between March and December 2001, with this amount being reduced to \$3,000 for contracts entered into between January and June 2002. The temporary nature of the CAG was designed to partly offset the large fall in construction activity after changes to the tax system in 2000.

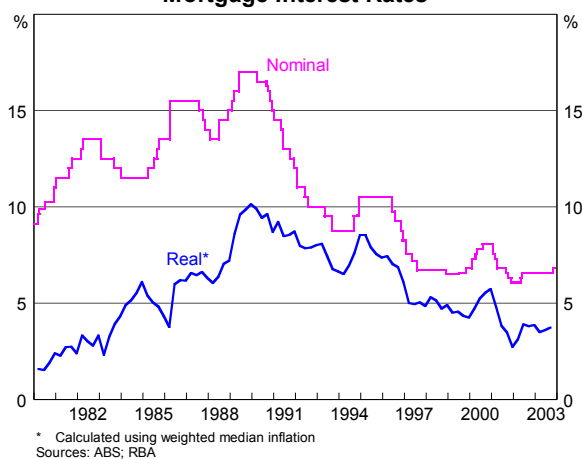
Overall, the net effect of these grants has been beneficial to first-home buyers. While the additional purchasing power arising from the grants has, at the margin, added to the upward pressure on house prices, the impact has been relatively small and cannot explain the large overall gains in house prices since the mid 1990s. Importantly, in terms of affordability, these grants have eased the “deposit gap” faced by many first-home buyers. As noted above, this is in contrast to stamp duty which has increased the “deposit gap”.

2.3 The effect of changed financial conditions

Financial conditions facing prospective homebuyers have changed substantially over recent years resulting in a considerable increase in the capacity of households to borrow. For most households, this is the critical factor in determining the price they are prepared to pay for a home. The change in financial conditions has had two important dimensions: a reduction in the cost of finance and an increase in its availability as a result of innovation and increased competition in the financial sector.

Mortgage interest rates in Australia have declined substantially from the levels that were typical in the 1980s and early 1990s (Graph 27). In large part this has reflected the shift to a low-inflation environment, which has been associated with generally lower policy interest rates both in Australia and around the world. Another influence on mortgage rates in Australia has been increased competition in the financial sector since deregulation, resulting in a significant compression of mortgage interest margins relative to the cash rate since the early 1990s. Currently mortgage interest rates stand at around 6½ per cent, roughly half the level that prevailed in the mid 1980s and an even greater reduction when measured from their late 1980s peak. Most of this decline occurred in the early to mid 1990s, with little net movement occurring since around 1997. While interest rates have continued to move up and down since then, they have done so around a lower average than was previously the case.

Graph 27
Mortgage Interest Rates



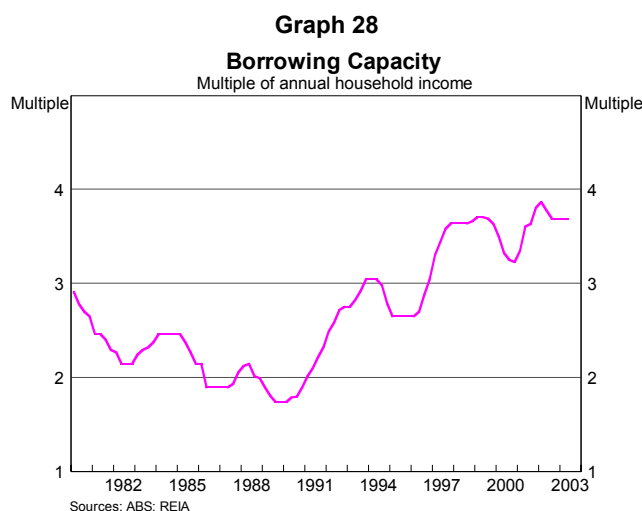
The effect of the increase in borrowing capacity has been reinforced by a marked increase in the availability of finance. Financial institutions have become much more willing to lend for housing, which is perceived as a low-risk activity, and have become more active in promoting their loan products, both to owner-occupiers and investors. New entrants to the home lending market have competed aggressively for market share and contributed to the decline in mortgage interest margins since the early 1990s. Increased competition and innovation have also brought an increase in the range of mortgage products on offer, with many lenders now offering products not widely available a decade ago (see Box 1 for a summary of these products). These products include home-equity loans, loans with flexible repayment schedules and redraw facilities, and interest-only loans. Loans with loan-to-valuation ratios in excess of 100 per cent are now also available, as are loans to individuals who, in years gone past, would have had considerable difficulty obtaining funding due to their work histories or other characteristics. In addition, as discussed further below, there have been a number of important innovations that facilitate entry to the investor market with very small initial cash outlays.

Other things held constant, it would be expected that a structural reduction in interest rates would encourage greater household borrowing and, to the extent the additional funds were directed to the housing market, would generate an increase in house prices. The question that arises then is whether this structural change can explain all or only part of the increase in house prices that has subsequently taken place. In order to address this question, movements in the key variables since the mid 1980s are summarised in Table 6. The base period of the mid 1980s taken here is chosen to be broadly representative of the situation of high average interest rates, high inflation and stable real house prices that prevailed prior to the property bubble in the latter part of that decade.

Table 6: Interest Rates, Household Debt and House Prices			
	1983–1987	1997–2003	June quarter 2003
Mortgage interest rates (per cent)			
– nominal	13.3	6.9	6.55
– real	5.2	4.4	3.6
Household debt (per cent to household income)	44.9	100.9	134.0
<i>Of which:</i>			
– owner-occupier housing	29.6*	59.3	76.0
– investor housing	5.2*	24.3	36.8
House prices [^] (ratio to average household income)			
– REIA measure	3.0	4.6	6.1
– CBA/HIA measure	2.9**	5.2	7.3

* Figures shown are for 1990
** From 1984
[^] Detached houses, capital cities.

As noted above, mortgage interest rates in nominal terms have roughly halved since the mid 1980s. This decline has significantly reduced the initial servicing cost associated with a given mortgage.¹⁸ For example, using the traditional benchmark that requires that interest plus principal mortgage repayments not exceed 30 per cent of gross income, a household today can borrow an amount equivalent to 3.7 times its annual income, compared with around two times income in the mid 1980s (Graph 28). In other words, the borrowing capacity of households relative to income is now almost double what it was in the mid 1980s.



This observation provides an initial benchmark for considering the impact of structurally lower interest rates: if household borrowing behaviour was entirely driven by households borrowing to the maximum extent of their capacity, we would expect the overall ratio of household debt

¹⁸ For a fuller discussion of this issue, see Stevens GR, “Some Observations on Low Inflation and Household Finances”, Reserve Bank of Australia *Bulletin*, October 1997; see also Reserve Bank of Australia *Bulletin*, “Household Debt: What the Data Show”, March 2003, pp 1–11.

to income to have increased by the same factor of just under two, as outlined above. However, that result would be based on an extreme assumption, and it is likely that the effect would be more muted, for two reasons:

- First, there is no necessary presumption that all households would want to respond to lower interest rates by correspondingly taking on more debt to an extent that would leave their initial loan repayments unchanged. In normal times some may prefer a more modest increase in debt that would allow their loan repayments to fall.
- Second, the reduction in mortgage rates has been much smaller in real than in nominal terms, since a large part of the reduction in nominal mortgage rates has been a reflection of lower inflation. As indicated in Table 6, real mortgage rates in recent years have averaged around 4½ per cent, only a modest reduction from the average of just over 5 per cent in the mid 1980s. The real debt service cost over the life of a loan has thus not come down by nearly as much as the fall in initial repayments, since inflation cannot be expected to reduce the real debt to the same extent as was typical in the past. To the extent that homebuyers take this into account in their borrowing decisions, they would increase their borrowing by less than the maximum increase indicated by the nominal repayment benchmark.

Given these considerations, it can be concluded that the structural reduction in interest rates since the mid 1980s would explain, at most, an approximate doubling in household borrowing relative to incomes over the period, and probably less. But in fact, the increase in household debt, as indicated in Table 6, has been considerably larger than that. Total household debt has increased from a ratio of around 45 per cent of income in the mid 1980s to 134 per cent by the June quarter 2003, and is still rising rapidly. Housing debt to owner-occupiers, the group that would be expected to respond directly to the increase in borrowing capacity in the way discussed above, has increased from around 30 to 76 per cent of income since 1990 (the earliest period for which this detail is available). Clearly, this increase has gone beyond what could be explained by the structural reduction in interest rates since the 1980s.

It is not possible to derive a mechanical link from the structural change in nominal interest rates to its expected impact on housing prices. An extreme assumption, along the lines already discussed above, would be that new homebuyers responded to the increase in borrowing capacity by commensurately increasing the amount they were prepared to pay for a home. For the reasons noted, if this had been fully capitalised into house prices it would explain at most a doubling of the ratio of house prices to income. The actual movement to date, according to the indices summarised in Table 6, has been an increase by a factor of

2–2½ over the period and, as discussed in detail in Chapter 1, these price indices are continuing to rise rapidly and at an increasing pace.

In summary, then, while the structural reduction in interest rates since the mid 1980s appears to explain a large part of the growth in housing-related debt and in house prices observed since that time, it is unlikely to account for these phenomena fully. This conclusion is also supported by a consideration of the relative timing of these events. As noted above, the increase in borrowing capacity relative to incomes was largely completed by around 1997. While the full take-up of this capacity, and its impact on house prices, could be expected to take some years, it would be reasonable to expect that the transition to a higher equilibrium level of prices would now be largely completed. In fact, house prices are not only still rising quickly but, in aggregate, have accelerated over the past year, even though the level of mortgage rates has been little changed for several years.

On this basis it seems clear that other factors beyond the change in interest rates have contributed to the increases in house prices and their recent acceleration. In this context, the general increase in the availability of finance, as a result of innovation and competition in the financial sector, has obviously been important in contributing to the growth of demand in the housing market over the past decade. As discussed in the following section, the impact of this development has been particularly evident in the rapid growth of demand from investors.

2.4 Demand for property as an investment

The extremely strong demand to purchase rental properties by household investors over recent years is unprecedented, both in terms of previous experience in Australia and experience overseas. The impact of this strong demand has been most evident in the inner-city apartment markets, although there has also been strong investor demand for apartments and houses in more established areas. The demand by investors for rental properties has added to the general upward pressure on house prices, and thus made it more difficult for first-time buyers to get a foothold in the market. It has also contributed significantly to the overall increase in household indebtedness, and the increased vulnerability of the household sector to a deterioration in the economy.

The strong demand for rental properties, and the accompanying price rises, has induced a considerable increase in the supply of apartments, particularly those for rent. While the number of people wishing to rent these apartments has also increased, partly as a result of demographic factors, the increase has not kept pace with the growth in the number of apartments available. The result has been the weakness in rents discussed in the previous chapter, and falls in prices in some areas.

Despite rental yields that are now very low, both by historical and current international standards (Table 7), investor demand has remained extremely strong. Indeed, as yields have declined further over the past year, the demand by investors appears to have increased further. Investors in Australia seem prepared to accept rental yields that are much lower than those required on commercial property and much lower than yields on rental properties in overseas markets.

Australian Property	
Residential Property ¹	3½
Commercial Property ²	
Industrial	9
Office	8
Retail	9
International Property – Residential	
United Kingdom ³	7½
United States ⁴	8
Canada ⁵	9½

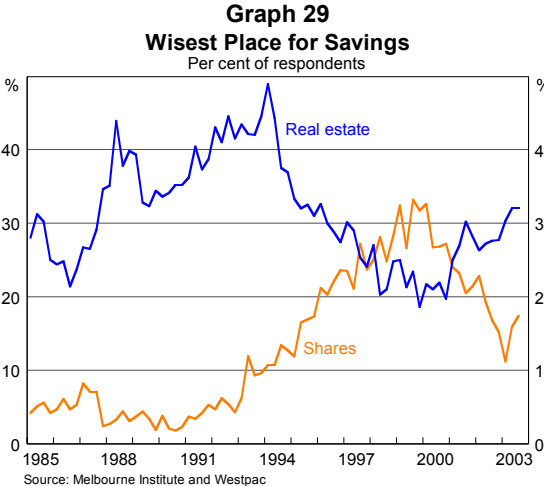
1. Gross rental yield on houses (Real Estate Institute of Australia).
2. Net rental yield (Property Council of Australia).
3. Average gross rental yield in England and Wales (Paragon Mortgages Buy-to-Let Index).
4. Estimate from industry sources.
5. Median gross rental yield on two-bedroom apartments in Toronto (Royal LePage Survey of Housing Prices).

To understand recent developments it thus important to understand why the demand from investors has been so consistently strong, and why the Australian household sector’s appetite for rental property investments has far outstripped that of households in other countries. Part of the answer obviously lies in the rapid increase in house prices during the period when prices were adjusting to lower interest rates. Investors who sensed early on the potential for such gains have been able to earn high rates of return from the purchase of rental properties. However, with the adjustment of prices to lower interest rates now almost surely complete, demand has remained very strong.

The continuation of strong investor interest partly reflects the extrapolation of past increases in prices. This is hardly surprising. Over recent decades, property has been a sound investment, with prices rising in most years. On those rare occasions when prices have declined, the falls have been modest, and even people who bought at the peak of the late 1980s boom have recorded healthy returns on their investments. As a result, many people believe that property prices will not fall over any reasonable investment horizon. This is notwithstanding the fact that prices have fallen noticeably in some other developed countries and, in Australia, they have fallen in real terms on a number of occasions.

To the extent that past experience has been extrapolated many investors may ultimately be disappointed with their returns on their property investment. While lower interest rates have clearly justified a higher level of house prices, they have not justified higher rates of increase on an ongoing basis. Many investors have probably not fully recognised this distinction.

Another important factor contributing to the attractiveness of residential property over recent years has been the weakness in equity markets around the world. The strong gains in property prices relative to equity prices have reinforced the idea that property is a preferable investment to shares. This is reflected in responses to survey questions on where is the wisest place for individuals to invest their savings (Graph 29). This perception has been reinforced by the corporate governance scandals, particularly in the United States, and the evidence that some high-profile providers of investment advice have had serious conflicts of interest. Many households see holding and managing an investment property themselves as one way to avoid such problems.



The strong demand for property as an investment is, of course, not just restricted to investors in rental properties; investment considerations can also be important for owner-occupiers. As house prices have risen over recent years, many owner-occupiers have been prepared to borrow as much as possible in order to maximise their exposure to the rising property market. In many cases, households have purchased the most expensive property that they could afford, partly in the hope that future capital gains would help fund their retirement. Other owner-occupiers have been prepared to borrow heavily to purchase a house given their concerns that further increases in prices could make it impossible for them to purchase a house in their desired location in the future.

Notwithstanding this investment demand from owner-occupiers it is the behaviour of investors in rental properties that is particularly unusual in the current boom. Against the backdrop of expectations of continuing capital gains, two aspects of the financing and

taxation treatment of investments in rental properties have been particularly important in underpinning this strong demand. These are:

- financial innovation that has allowed investors to purchase an investment property with limited, or no, cash outlay; and
- the relatively small cash outlay required to cover the ongoing costs of owning an investment property even when the rental yield on the property is very low.

Many investors are able to purchase an investment property through accessing equity in their existing home, without having to put in any cash up front. This outcome reflects the fact that in assessing loan applications, financial institutions will often compare the total value of debt on the owner-occupier and investment properties with the combined value of the two properties, in effect allowing 100 per cent debt financing of the investment property. Provided investors can service the loans from their overall income, lenders are typically not concerned that interest payments and other expenses far exceed prospective rental income.

More generally, the willingness of financial institutions to lend to investors has greatly increased over recent years. In past decades, individual investors could have considerable difficulty obtaining finance for an investment property, often having to rely on a combination of their own savings and funding from non-bank sources. In contrast, today, banks compete aggressively in this area, marketing investor loans to their entire customer base. They also offer products specially designed to be attractive to investors, including split-purpose and interest-only loans (see Box 1). Reflecting this change in attitude, lending criteria on investor loans are now, generally, not materially different to those for loans to owner-occupiers. And the interest rate charged is the same as that charged on owner-occupied loans, in contrast to the situation that applied until the mid 1990s when investors were charged a premium of 1 percentage point.

Another innovation that has allowed investors to obtain an exposure to the property market with minimal up-front cost is the deposit bond. While these bonds have helped lower the cost of bridging finance they have also permitted investors to purchase a property off-the-plan for an up-front cost of a few thousand dollars, a fraction of the cost of the traditional 10 per cent deposit (see Box 1). In doing so, they allow investors to obtain a highly leveraged exposure to the property market during the construction phase. While, ultimately, the investor needs to obtain funding to effect settlement of the purchase, it has not been uncommon to use these bonds to speculate on prices, with the investor hoping to on-sell the property before settlement is due.

Overall, the terms under which investors can access finance in Australia are considerably more generous than those that apply in other countries studied in preparing this submission. In most countries, investor loans are treated more like business loans than owner-occupier housing loans, and they are not marketed as aggressively as they are in Australia. Moreover, instruments equivalent to the deposit bond do not appear to exist in other countries. In the United States, individual investors in rental property are generally charged interest rates 25 to 100 basis points above those charged to owner-occupiers. Similarly, in Canada, while posted interest rates tend to be similar for owner-occupier and investment loans, banks negotiate larger discounts for owner-occupiers than for investors.¹⁹ In the United Kingdom too, loans to investors usually attract a higher interest rate than that charged on owner-occupier loans, although the differences have tended to narrow over time. Stricter lending criteria are also generally applied, with lenders often requiring that rental income exceed interest payments.²⁰ In general, the mortgage products offered in these countries also permit less flexibility than is available in Australia for investors to draw-down equity on their existing owner-occupied property to help finance an investment property.

The second important factor that has underpinned investor demand is the fact that in many cases, investors need to make only a small ongoing cash outlay, even if the weekly rent falls far short of the investor's expenses (including interest). It is not uncommon, for example, for promoters of investment in rental properties to suggest that due to the operation of the tax system, investors can purchase an investment property worth \$400,000 or \$500,000 for as little as \$50 per week. In addition, little or no up-front contribution from the investor is required.

Given current rental yields and realistic assumptions about interest rates and expenses, rental income for investors that have borrowed recently to purchase an investment property will be less than half their expenses, including interest. As discussed in the previous chapter, gross rental yields on apartments currently stand at around 3½ per cent, and after expenses, including body corporate fees, rates, agent's fees and maintenance, net yields are typically below 2½ per cent. In contrast, the average interest rate on housing loans is currently around 6½ per cent. This difference between net yields and mortgage rates means that the

¹⁹ Moreover, the Canada Mortgage and Housing Corporation (which is the monopoly provider of mortgage insurance for rental housing) has a lower maximum loan-to-valuation ratio (85 per cent) for investors than for owner-occupiers, although if the borrower is willing to be personally liable for the debt, this difference is eliminated.

²⁰ While loans with loan-to-valuation ratios of up to 85 per cent are available in the United Kingdom, loan-to-valuation ratios are normally in the range of 70–75 per cent, rather than the usual 80–85 per cent range for loans to owner-occupiers. Where loans are based on the rental income, rather than the borrower's overall income, a maximum loan-to-valuation ratio of 65 per cent is normally applied and the gross rental income must exceed 130 per cent of the interest payments.

purchaser of a \$400,000 rental property financed with debt would be out of pocket (before tax) by over \$300 per week, or over \$15,000 per year.

The actual cash-flow position of many investors is, however, significantly improved by the taxation treatment of rental properties.²¹ In particular, the ability to claim depreciation deductions, and the ability to offset tax losses on the investment property against other income (commonly known as negative gearing), can substantially reduce the cash-flow burden from low-yielding rental property investments.²² It is not unusual, for example, for depreciation deductions on buildings and fixtures and fittings to amount together to \$10,000 per year on a new \$400,000 apartment. Further, with net yields and interest rates at current levels, depreciation deductions mean that an investor could reasonably incur tax losses in excess of \$25,000 per year on a \$400,000 apartment. As illustrated in Box 2, this significantly reduces the weekly out-of-pocket expense of holding the investment property. In the example provided, the \$400,000 investment property runs at a cash deficit of \$331 per week before tax, but this is reduced to \$81 per week after tax.

The desire by taxpayers to minimise their tax is long-standing. It is particularly important for individuals paying the top marginal rate of tax. In Australia, this top rate cuts in at a relatively low level of income (\$62,501) by international standards; according to survey data, over 20 per cent of full-time wage and salary earners have gross incomes exceeding this threshold. With negatively-gearred investments particularly attractive to individuals facing high marginal tax rates, a high share of Australian taxpayers are attracted to property investment to lighten their tax burden. This interaction of high marginal tax rates and negative gearing is frequently emphasised by the property seminar industry.

As with access to finance, the taxation arrangements for rental properties in Australia tend to be more favourable to investors than are the arrangements in other countries studied for this submission. The Australian arrangements, in conjunction with the relatively high marginal tax rates faced by many taxpayers, mean that investors holding low-yielding properties that are highly leveraged face a substantially lower ongoing cash-flow deficit than would investors in most other countries. This lower carrying cost has contributed to the continuing strong investor demand.

Under the Australian taxation system, there are no restrictions on the ability of taxpayers to negatively gear investment properties. There are no limitations on the income of the

²¹ Assuming that the investor has gained approval from the Commissioner of Taxation to reduce the amount of tax withheld from their income in anticipation of a loss from the property investment.

²² Interestingly, the term “negative gearing” does not appear to be used in other countries examined in this submission.

taxpayer, on the size of losses, or the period over which losses can be deducted. As discussed above, under plausible assumptions an investor purchasing a \$400,000 property recently might have tax losses of \$25,000 per year on the investment. Moreover, these losses can extend for many years into the future. If, for example, the net rental yield on the property is 2½ per cent, and rents increase at their average rate over the past decade (2½ per cent), tax losses would continue for more than thirty years if the property is financed by an interest-only loan. As discussed in Box 3, the rent on the property would need to increase by at least 10 per cent per year for the investment to be cash-flow positive within a decade.

In contrast to the arrangements that exist in Australia, negative gearing is not permitted in the United Kingdom, except in respect of “furnished holiday accommodation income”, and is not relevant in the Netherlands given their tax treatment of investment income.²³ In the United States, only taxpayers with an annual income of less than US\$100,000 are able to fully negatively gear investments in residential property, and even then they must meet certain “activity” tests, and losses in any one year cannot exceed US\$25,000.²⁴ In Canada, negative gearing is allowed, but only if the losses do not arise from depreciation expenses. Furthermore, historically, losses have only been permitted for a limited number of years, although recent court decisions have weakened this restriction. Additional details of the arrangements in the various countries are provided in Table 8.

The treatment of depreciation in Australia also appears to be quite favourable, particularly when considered in conjunction with the fact that there are no restrictions on negative gearing. As discussed above, for many investors in new apartments, depreciation deductions can make a material difference to the cash-flow attractiveness of the investment. By way of contrast, there are no deductions for depreciation in the United Kingdom and the Netherlands. In North America, rates of depreciation for tax purposes are higher than those in Australia, although the restrictions on negative gearing mean that not all investors can take advantage of depreciation deductions to reduce their current tax bill. Table 9 provides further details on the arrangements in each of the country studied.

One aspect of depreciation that does not typically receive much attention, but is important for some investors, is its interaction with the capital gains tax (see Box 4 for an illustration). In those countries that permit depreciation deductions, the deductions reduce the cost base for

²³ In the Netherlands, savings and investments are assumed to earn a fixed yield of 4 per cent, on which a 30 per cent income tax is levied. The assumed yield is applied to the net value of the savings/investments (ie the value after debt has been deducted). Separate arrangements apply to the taxation of owner-occupied housing.

²⁴ This threshold was introduced in 1986 and has been unchanged since that time.

calculating capital gains tax, and so increase the capital gains tax liability upon sale. Where the capital gains tax is levied at a lower rate than the income tax rate, this represents a significant advantage to the taxpayer. In Canada, where the capital gains tax is at half the income tax rate as in Australia, the authorities have addressed this point by applying the full income tax rate to that part of the capital gain arising from the downward adjustment to the cost base. The lower capital gains tax is then applied to the remainder of the capital gain. In Australia, the lower capital gains tax is applied to the entire capital gain.

The overall importance of negative gearing and depreciation deductions in Australia is evident in the fact that in 1999/00 (the latest year for which relevant data are available), 54 per cent of Australian taxpayers earning rental income recorded a tax loss on their investment.²⁵ In both 2000/01 and 2001/02, as in a number of other years over the past decade, investors, in aggregate, recorded an income tax loss on their investment in rental properties. In each of the other countries studied, investors, in aggregate, earned a positive return.

Another difference between investors in Australia and elsewhere is that in most countries the earning of rental income is seen as the most important reason for investing in rental properties. In the United Kingdom, for example, surveys suggest that two-thirds of investors plan to hold their rental property for more than 10 years and investors routinely report that rental income is the most important rationale for investment.²⁶ Similarly, in the United States, surveys indicate that only 10 per cent of rental properties are held by investors whose primary rationale for investing is long-term capital gain.²⁷ This seems to stand in contrast to the situation in Australia where properties are commonly marketed on the assumption that they do not earn positive taxable income for a considerable period.

²⁵ Precisely comparable figures are not currently available for other countries. Although in the United States 51 per cent of taxpayers who declared rental income in 2000 reported an overall loss, at least some of these would have had to carry the loss forward rather than write it off against other income.

²⁶ See Association of Residential Letting Agents, *Survey of Residential Landlords*, 2003.

²⁷ See US Census Bureau, *Property Owners and Managers Survey*, 1995–96.

Table 8: Restrictions on “Negative Gearing”

Australia	No restrictions.
Canada	<p>Losses on a rental property can be offset against all other forms of income, provided that the losses do not arise from depreciation (capital cost allowance) charges. In calculating whether a loss has been incurred, non depreciation costs must be deducted before depreciation costs.</p> <p>For rental losses to be deductible against other income, the taxpayer needs to satisfy the “reasonable expectations of profits” test. Historically, this test has required the taxpayer to be able to demonstrate that the rental property will produce a profit within a reasonable number of years. Recent court decisions have, however, effectively weakened this test.</p>
The Netherlands	Negative gearing not possible. Taxation of investments is based on an assumed yield of 4 per cent.
United Kingdom	Losses on a rental property cannot be offset against non-rental income. Instead, they must be carried forward and deducted from future rental income.
United States	<p>Losses on a rental property cannot be offset against non-passive income if the taxpayer’s gross income exceeds US\$150,000.* Instead, they must be carried forward and deducted from future profits from “passive” income.</p> <p>For taxpayers with a gross income of less than US\$100,000, rental losses of up to US\$25,000 can be claimed against other income, provided the taxpayer “actively participates” in managing the property. For taxpayers with incomes between US\$100,000 and US\$150,000, the maximum rental loss able to be claimed, provided the active participation test is satisfied, is reduced by \$0.50 for every dollar of income over \$100,000.</p>

* This limit applies to married couples, and is halved if each person files separately.

Full negative gearing is permitted if the taxpayer meets the “real estate professional” test. This test requires the taxpayer to perform more than 750 hours of property-related work during the year, and more than half of all services performed during the year were in property businesses in which the taxpayer actively participated.

Table 9: Treatment of Depreciation

	Rate for Buildings	Rate for fixtures and fittings	Other details
Australia	2.5% (straight line depreciation over 40 years)	5–20% (straight line)	Rental property buildings can be depreciated in Australia provided they were built after July 1985. ¹ Depreciation is fully deductible against non-rental income and reduces the cost base for calculation of capital gains. ²
Canada	4% (declining balance)	20% (declining balance)	Rental property buildings can be depreciated on an accrual basis using the declining balance method. Depreciation deductions cannot be used to create or increase a rental loss. Where depreciation is claimed it reduces the cost base for calculating capital gains tax.
The Netherlands	not applicable	not applicable	Taxation of investments, including rental properties, is based on an assumed yield of 4 per cent.
United Kingdom	0%	0%	There are no depreciation deductions for “residential” rental property buildings. ³ For properties that are rented furnished, a deduction of 10 per cent of rental income can be claimed for wear and tear. The cost of replacing fixtures and fittings is deductible for non-furnished rental properties.
United States	3.64% (straight line depreciation over 27.5 years)	20% (either declining balance or straight line depreciation allowed) ⁴	As in Australia, rental property buildings can be depreciated on an accrual basis using straight line depreciation. Depreciation charges that lead to an overall tax loss can only be used to offset tax payable on other income if negative gearing is allowed (see Table 3). Depreciation deductions reduce the cost base for calculating capital gains tax.

1. For buildings built before 1985, only those used for short-term accommodation for travellers and non-residential buildings are depreciable.

2. The impact of depreciation deductions on the cost base for capital gains differs if the property was purchased before 1997.

3. Furnished holiday letting accommodation does not count as residential accommodation.

One additional factor that has helped fuel demand for investment properties over recent years is the investment seminar industry. Operators of these seminars have been able to draw large numbers of potential investors, explaining how rapid price increases and favourable taxation treatment can make highly-leveraged property investments attractive, even when rental yields are low. While these seminars have not caused the boom in prices, they have contributed to its speculative elements. One difficulty is that much of the advice is provided outside the regulatory framework that applies to other types of financial advice. While securities and other financial advisors have significant obligations regarding disclosure and the suitability of advice, no such requirements apply in respect of real estate investment advice (see next chapter). The result has been that there has been relatively little oversight of the sometimes extravagant claims made in these seminars, or the conflicts of interest that can arise for those conducting the seminars.

Finally, another factor that has contributed to Australian households being more willing to purchase an investment property than households in other countries is that landlords have more control over their properties than is often the case elsewhere. In some jurisdictions in the United States, for example, it can be very difficult to evict tenants, even if they have not paid the rent or have damaged the property. In other jurisdictions, rent controls, or the fear of future rent controls, reduce the attractiveness of rental properties. As a result of these concerns, rental properties are generally considered a relatively high-risk, time-consuming investment by many households in other countries.

Box 1: Major Innovations in the Provision of Housing Finance

Product	Description
Home-equity loans	These loans provide a line of credit secured by a mortgage against an existing property and can be used for a range of purposes, including renovations or the purchase of an investment property. In some cases no repayments are required for a number of years, provided the outstanding debt remains below an agreed limit (generally up to 80 per cent of the value of the property). Currently, home-equity-type loans account for around 12 per cent of loans outstanding that are secured by residential property.
Mortgages with flexible repayment schedules and redraw facilities	These arrangements allow borrowers to manage a temporary loss of loan servicing ability or to access loan repayments that have been made in excess of the minimum repayments required by the lender. As such they reduce the need for borrowers to maintain precautionary savings in low-interest deposit accounts and can offer a tax-efficient form of saving. The most flexible of such arrangements combine a home loan account, a transactions account and credit card account into the one facility.
Deposit bonds	These bonds remove the need for the purchaser of a property to pay a deposit at the time contracts are exchanged. Instead, the purchaser pays the bond's issuer (typically an insurance company) a fee in return for a guarantee that an amount equivalent to the deposit will be paid at settlement. For short-term bonds, this fee can be measured in hundreds of dollars rather than the tens of thousands required for a conventional deposit. Even bonds with terms of up to three years, used to purchase property "off-the-plan", are relatively cheap, allowing investors to gain a highly leveraged exposure to the property market during the property's construction phase. Developers report that deposit bonds have been used by up to 70 per cent of purchasers in some projects. It is estimated that they are used in up to 20 per cent of Sydney residential transactions, the market where their use is most widespread.
Interest-only loans	For investors, the appeal of these loans lies in the scope for greater tax deductions than otherwise. For owner-occupiers, these loans may provide an opportunity to invest deferred principal payments in higher-yielding products. Some lenders do not require any principal repayment for 20 years although a five-year period is the most common.
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High loan-to-valuation ratio (LVR) loans	A range of financial institutions offer loans of between 97 per cent and 110 per cent of the property's purchase price. While such products have been available for at least two years, most high LVR loans have been made in the past six months. Various restrictions on the type of property (for example, investor and/or inner city) are imposed in an effort to reduce the lenders' credit exposure. In addition, high LVR loans usually attract a higher interest charge.
Low documentation loans	These loans are designed for borrowers that are unable to gain approval for traditional lending products due to insufficient documentation – usually due to their employment situation (self-employed, seasonal or contract workers). These loans typically carry an interest rate 60–80 basis points above the standard variable mortgage rate and have a maximum LVR of 75–80 per cent.
Acceptance of other security	One financial institution has recently introduced a home loan that allows customers to use the equity in their car as part of the security for the loan. The loan is principally designed for borrowers who wish to consolidate an existing mortgage and other outstanding debts, but are otherwise unable to meet minimum LVR requirements.
Split-purpose loans	<p>These loans allow a borrower to split a loan into two sub accounts, one for a home loan and the other for an investment loan. In the initial years, all loan repayments are directed to the home loan account with the interest due on the investment loan being capitalised. Subsequent interest payments and tax deductibility relating to the investment property are thus greater than otherwise.</p> <p>The Commission of Taxation has recently been granted leave to appeal to the High Court regarding the Federal Court's decision that this type of product is not primarily designed to obtain a tax benefit.</p>
Vendor finance loans	Under these arrangements, a “mortgage wrapper” obtains a standard mortgage over a property from a mainstream lender and on-sells the property to a third party (who occupies it) under an installment sales contract. The wrapper retains ownership of the property until the occupant makes all of his/her installments, that is, until the wrapper's loan to the occupant is fully repaid. The interest rate paid to the wrapper is typically 2–2½ percentage points higher than the standard mortgage rate. In addition, the mortgage wrapper usually requires the occupant to make repayments of principal well in excess of the purchase price paid by the wrapper – sometimes up to 25 per cent in excess.
For further details see Reserve Bank of Australia <i>Bulletin</i> , “Innovations in the Provision of Finance for Investor Housing”, December 2002, pp 1–5; Reserve Bank of Australia <i>Bulletin</i> , “Recent Developments in Housing: Prices, Finance and Investor Attitudes”, July 2002, pp 1–6; and Reserve Bank of Australia <i>Bulletin</i> , “Recent Developments in Low-deposit Loans”, October 2003, pp 1–5.	

Box 2: Out-of-pocket cost of holding a rental property

This box provides some calculations on the carrying cost of holding a rental property with a gross rental yield of 3½ per cent.

The purchase price of the property is assumed to be \$400,000 and the investor is assumed to have financed the purchase entirely with an interest-only loan, paying an interest rate of 6.6 per cent.

Expenses (eg insurance, agent's fee and body corporate charges) are assumed to be equal to 1.2 per cent of the value of the property, and annual depreciation charges are assumed to be \$9,550 (see Box 4 for further details of depreciation). The investor is assumed to have taxable income from other sources equal to \$95,000.

Based on these assumptions, Table 1 summarises the weekly cash flows associated with this investment.

Table 1: Weekly Cash Flows

Rent	\$269
Rental expenses	\$92
Interest payments	\$508
Cash flow (before tax)	-\$331
Depreciation deductions	\$184
Taxable Income	-\$515
Reduction in tax on other income*	\$250
<i>Out-of-pocket expense</i>	<u>\$81</u>

* Assumes that the ATO approves the investor's application under Section 15.15 of the *Taxation Administration Act* to reduce tax withheld from other income.

Given the relatively low rental yield, the investor's weekly rental income is less than half total rental and interest expenses. If depreciation deductions and negative gearing were not permitted, as in the United Kingdom, the investor would need to find \$331 per week from other sources in order to cover these losses.

However, once depreciation and negative gearing are allowed, the weekly out-of-pocket expense on the investment property falls to just \$81. This reflects the fact that depreciation deductions increase the tax loss to \$515 and this entire loss can be offset against other income, reducing the investor's tax bill by \$250 ($\515×0.485) per week.

Some promoters of investment property suggest that investors can claim even larger deductions for depreciation than used in this box. This would again reduce the weekly contribution that the investor would be required to make. So too would using some equity to finance the purchase of the property. For example, if the investor took out a loan equal to 85, rather than 100, per cent of the value of the property, the weekly out-of-pocket expense on the investment property would be around \$42, rather than \$81.

Box 3: Rental property – time to cash-flow positive

This box provides some calculations on the time taken for a rental property to become cash-flow positive under various scenarios.

The purchase price of the property is assumed to be \$400,000 and the investor is assumed to have taken out an interest-only loan of \$340,000 (ie the loan has an LVR of 85 per cent) at 6.6 per cent. It is also assumed that, initially, annual rental income less expenses is equivalent to 2½ per cent of the purchase price.

If rents (and expenses) on this investment property grow at 2½ per cent per year (the average rate seen over the past decade), it will take 34 years for this investment to generate positive cash flow (Table 1). If depreciation is included in the calculations, tax would not need to be paid until the 40th year and the cumulative tax losses would be considerably larger (based on the depreciation assumptions used in Box 4).

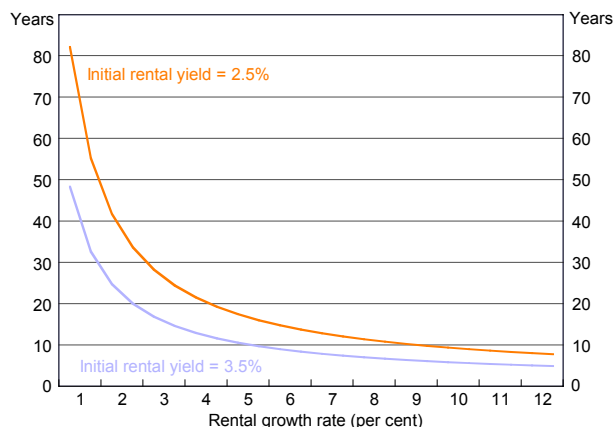
Table 1: Rental Income Cash Flows

Year	Rent	Interest	Rent – Interest
1	\$10,000	\$22,440	–12,440
10	\$12,489	\$22,440	–9,951
20	\$15,987	\$22,440	–6,453
30	\$20,464	\$22,440	–1,976
40	\$26,196	\$22,440	3,756

Obviously, the faster that rents grow, the shorter is the time taken for the investment property to become cash-flow positive (Graph 1). If, for example, rents were to increase at 5 per cent per year, it would take 18, rather than 34, years for the property to generate positive cash flow. Only if rents increased by at least 10 per cent per year would the property be cash-flow positive within a decade.

If the initial net rental yield is 3½ per cent, rather than 2½, the property becomes cash-flow positive more quickly, although for plausible assumptions about rental growth it still takes many years. For example, if rents grow at 2½ per cent per year then the property will take 21 years to become cash-flow positive. If they grow at 5 per cent, it will take 11 years. In contrast, if net rental yields are much higher, say 6 per cent, then the investment is cash-flow positive in the first year.

**Graph 1
Time to Positive Cash flow**



Box 4: Alternative treatments of depreciation

This box compares the effect of various treatments of depreciation over a 10-year period on the returns earned by an investor in a rental property.

The purchase price of the property is assumed to be \$400,000 which can be broken down as follows:

Value of land	\$200,000
Cost of construction	\$130,000
Value of fixtures	\$70,000
Purchase price	<u>\$400,000</u>

The depreciation rate on buildings is 2½ per cent per year, and the average depreciation rate on fixtures, etc is taken to be 9 per cent per year. Total depreciation expenses are therefore \$9,550 annually (\$3,250 for buildings and \$6,300 for fixtures).

The property is assumed to increase in value at 5 per cent per year, so that its value at sale in 10 years' time is \$651,558. Given the purchase price of \$400,000, the cost base for purposes of calculating capital gains (after taking account of stamp duty and other expenses, but before depreciation) is assumed to be \$430,000. The marginal income tax rate is taken to be 48.5 cents in the dollar, and the capital gains tax is half this rate.

Given these assumptions it is possible to compare three different treatments of depreciation.

The UK treatment: No depreciation deductions are allowed and correspondingly there is no adjustment to the cost base for calculating capital gains tax.

The Canadian treatment: Depreciation deductions are allowed, but when applying the capital gains tax, the lower rate does not apply to that part of the calculated capital gain arising from depreciation.

The Australian treatment: Same as the Canadian treatment, but the standard capital gains tax is applied to entire capital gain.

To illustrate the differences arising from depreciation the following examples abstract from complications arising from the taxation of rental income and restrictions on negative gearing. The treatments are compared using the current Australian marginal tax rates on income and capital gains.

Under the Canadian and Australian treatments, depreciation deductions reduce tax payable by \$4,632 per year ($0.485 \times \$9,550$). The taxpayer is able to invest this money and thus earn interest. Over a 10-year period total interest (after tax) would amount to \$5,753 assuming an interest rate of 5 per cent.

When the property is sold, capital gains tax is levied in all three cases, as shown in Table 1. The capital gains tax is lowest under the UK treatment, as there is no adjustment to the cost base for previously claimed depreciation. It is highest under the Canadian treatment due to capital gains being levied at the full income tax rate on part of the capital gain.

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Table 1: Capital Gains Tax on Sale Price of \$651,558

Treatment	Cost base after depreciation	Calculated Capital Gain	Tax Rates	Capital Gains Tax
UK	\$430,000	\$221,558	\$221,558@0.2425	\$53,728
Canada	\$334,500	\$317,058	\$221,558@0.2425 \$95,500@0.485	\$100,045
Australia	\$334,500	\$317,058	\$317,058@0.2425	\$76,887

The overall position of the investor under each of the three treatments is shown in Table 2.

Under the current Australian treatment, the investor is better off by around \$29,000 in 10 years' time relative to the outcome if the UK treatment applied, and around \$23,000 relative to the outcome if the Canadian treatment applied. This is a substantial difference. The main reason for this difference is that in Australia investors receive a tax benefit at their marginal tax rate for depreciation deductions, while all of the calculated capital gain is taxed at half the marginal tax rate.

The difference between the Canadian and UK treatments results from the fact that under the Canadian system, investors receive a benefit by being able to claim deductions for depreciation through time while only having to pay capital gains tax at the point of sale (and not through time). Investors in Australia receive the same benefit.

Table 2: Net Effect of Taxation Treatment

Treatment	Benefits from depreciation deductions		Capital gains tax (-)	Net effect
	Reduced tax over 10 years	Interest earnings (after tax)		
UK	\$0	\$0	\$53,728	- \$53,728
Canada	\$46,320	\$5,753	\$100,045	- \$47,972
Australia	\$46,320	\$5,753	\$76,887	- \$24,814

3. Policy Considerations

This chapter of the submission discusses various areas that could be examined further in addressing the overall affordability of home ownership.

The focus of the chapter is the demand for housing. As noted earlier, the Bank is of the view that the increase in house prices over recent years is not primarily the result of a shortage of overall supply of new housing. The Bank, however, recognises that changes on the supply side have the potential to affect overall housing prices, particularly in the medium term, so it is appropriate for the Productivity Commission to conduct a thorough analysis of the supply side of the housing market.

In assessing alternative proposals that affect the demand side it is important to keep in mind the experience of the past decade. As argued in the previous chapter, strong increases in housing demand from the mid 1990s onwards, largely as a result of improved access to finance and demand by investors, were readily translated into higher house prices. As a result, it has become more difficult for first-home buyers to obtain the necessary funds for a deposit and other establishment costs. The increases in house prices over this period have more than offset the contribution to affordability arising from lower housing interest rates.

An important lesson from this experience is that simply adding to the capacity of the household sector to pay more for residential property does little to improve overall affordability. Indeed, by pushing up prices it can make it more difficult for those who do not already own a property to get a foothold in the market.

A number of recent proposals that seek to improve affordability by further enhancing access to finance, if implemented without other changes, would inevitably lead to a further increase in the overall demand for housing. These proposals include:

- the promotion of shared-appreciation mortgages;
- the development of parental-pledge mortgages;
- wider availability of loans with high loan-to-valuation ratios; and
- access to superannuation for the purposes of funding the purchase of a home.

The main effect of policies that add to demand would be further upward pressure on housing prices. While those households that were in a position to take early advantage of the implementation of these proposals would benefit, in the medium term, prices would be likely to rise in line with the increase in overall purchasing capacity. This suggests that if initiatives

to improve the affordability of home purchase by first-time buyers are deemed necessary, and if they are to have more than a temporary effect, they need to be narrowly targeted so as to limit their effect on overall demand. Importantly, they should also be combined with other changes that reduce demand elsewhere, leaving the overall demand for housing broadly unchanged.

One narrowly targeted response worthy of further consideration is reducing the rate of stamp duty that currently applies to many first-home buyers. As discussed in the previous chapter, the general rise in house prices has meant that the burden posed by stamp duty has grown in magnitude over recent years. Alleviating this burden would reduce the “deposit gap” faced by many first-home buyers, and could be expected to have only a limited effect on overall prices.

The main way in which the current mix of demand could be altered is through a reduction in demand by investors. Reduced investor demand would allow scope for increased demand from those purchasing a house for the first time, without adding to the overall pressure on demand and prices.

Addressing the issue of investor demand might also be justified on other grounds. As discussed in the previous chapters, the central role played by investors in the current housing boom is quite unusual by international standards. By adding to the speculative dynamics in the market, the activity of investors has not only pushed up house prices, but has also contributed to an increase in the overall vulnerability of the household sector to a deterioration in economic conditions. Policies that had the effect of reducing the strongly procyclical nature of investor demand could have the dual advantages of creating more room for first-home buyers and contributing to a more stable housing market.

As discussed in the previous chapter, the main factors underpinning the unusually strong investor demand in Australia are the favourable terms on which lenders are prepared to provide finance to investors, the taxation treatment of investor housing, and the active promotion being undertaken by the property investment seminar industry.

3.1 Financing

The liberal access to finance enjoyed by investors in the residential property market is a by-product of financial liberalisation and strong competition in the mortgage market. These developments, on the whole, have served the Australian community well. They have greatly increased the availability and flexibility of finance and reduced the cost of borrowing. There is no case for turning the clock back on these changes.

An important issue, nonetheless, is whether competition and unrealistic expectations by lenders have led to pricing that does not adequately cover the credit risk associated with loans to investors, particularly those that are highly leveraged and that own properties where vacancy rates are high. A related issue is whether lenders are holding sufficient capital to cover these types of loans. In this regard, the recent work by the Australian Prudential Regulation Authority (APRA) assessing the vulnerability of deposit-taking institutions to a downturn in the housing market is both timely and very welcome. While the findings were for the most part reassuring, the work did highlight deficiencies in information and risk-monitoring systems in some financial institutions. The Bank welcomes the fact that APRA will continue to monitor the situation closely and that it will follow up the results of the stress test with individual institutions.

3.2 Taxation

The taxation arrangements that apply to rental properties in Australia are the same as those that apply to other forms of investment; there are no concessions or restrictions that apply specifically to rental properties. Notwithstanding this, the taxation arrangements in Australia are more favourable to investors in residential property than are the arrangements in other countries studied in preparing this submission.

This more favourable treatment has played a role in investors being prepared to accept rental yields that are lower than those seen in other countries. While taxation arrangements are not the source of the current speculative activity in the housing market, they may affect the price dynamics once the attractiveness of investing in housing has improved for other reasons.

The Bank does not have specific recommendations for modifying the taxation treatment of residential property. It does, however, encourage the Productivity Commission and others more expert in tax matters than the Bank, to examine the current arrangements, and in particular, those areas where the treatment in Australia differs from that commonly seen overseas. The work undertaken in preparing this submission has highlighted three relevant areas that appear worthy of further examination.

- The ability of investors to negatively gear an investment property for many years.

As discussed above, an investor in Australia can under plausible assumptions claim tax losses on an investment property for many decades. In most other countries, limitations on negative gearing and higher rental yields make such an outcome unlikely.

- The benefit arising from depreciation due to differences in income and capital gains tax rates.

As noted above, depreciation reduces the current income tax liability of the investor, but increases the future capital gains tax liability. The treatment is relatively favourable to investors, given the difference in the income and capital gains tax rates.

- The general treatment of property depreciation.

The treatment of depreciation varies considerably across countries. In the United Kingdom, depreciation deductions are not permitted, and correspondingly, there is no adjustment to the cost base for purposes of calculating capital gains tax. It is less advantageous to investors than the Australian approach, particularly in terms of cash flow, as the amount of tax payable is higher during the period over which the property is held, though this is largely offset by a lower capital gains tax liability upon sale. The issue of obtaining a tax deduction for depreciation at one rate and paying capital gains tax at another rate also does not arise.

The Bank does not see a case for an outright prohibition on negative gearing for investment in residential property. The ability to offset losses from one activity against income or profits from another is part of the normal operation of the Australian tax system, and applies to a wide range of investments and business activities.

Ideally, any modifications to the current taxation system should apply, wherever practical, to all investments so as to ensure the neutrality of the taxation system across investment classes. Importantly, any evaluation of potential modifications would also need to consider the timing of their implementation and the implications for both existing and new investors, as well as on the overall operation of the rental market.

Another tax-related issue is the enforcement of existing laws. The recent announcement by the Australian Taxation Office (ATO) that it has increased its scrutiny of rental deductions is a welcome step. As part of its current compliance program the ATO has sent out around 15,000 letters explaining to taxpayers the common mistakes made in claiming rental deductions. It has also asked another 5,000 taxpayers to complete a rental expenses schedule and lodge it with this year's tax return. It is a matter of priority that these efforts continue and that the existing laws are rigorously enforced.

3.3 Property investment advice

As discussed in the previous chapter, much of the advice provided by the investment seminar industry falls outside the regulatory framework that applies to other types of financial advice. While ASIC and the ACCC both have consumer protection powers, the overall regulatory framework governing the provision of advice on real estate investments has not kept pace with the rapid change in the industry and the increase in the number of ordinary households with property investments. As ASIC has noted, the current regulatory regime was not designed for the purpose of regulating the provision of financial advice. In particular, while securities and other financial services advisors have significant obligations under the Corporations Law regarding disclosure and the suitability of advice, no such requirements apply in respect of real estate investment advice.

In its review of the provision of real estate advice in 1999 and 2000, ASIC recommended that where real estate agents give advice based on the investor's individual circumstances they should be subject to authorisation requirements, disclosure requirements, standards of conduct, and investor redress mechanisms that are comparable to those that are available to retail investors obtaining personal securities advice.²⁸ Where the advice is more general, ASIC recommended that there should be disclosure to the effect that:

- the advice is general in nature and not based on the circumstances of the individual investor;
- intending purchasers should assess the suitability of a property in light of their own individual needs, perhaps with the help of a licensed financial advisor; and
- any conflicts of interest of the advisor (for example, a relationship with the property developer) should be made known to intending purchasers.

The recent initiative of the Commonwealth and state governments to establish a working group, including the ACCC and ASIC, to develop a common framework for regulating real estate investment advice is an important step. Hopefully, this group will be able to make concrete progress quickly.

²⁸ For further details, see Australian Securities and Investments Commission, "ASIC review of financial advising activities of real estate agents: February 2000" and Australian Securities and Investments Commission, "Review of the financial advising activities of real estate agents: Interim report", July 1999.

Appendix: Organisations Contacted

Below are listed the organisations met with or consulted by RBA staff regarding the material presented in this submission.

Canada

Bank of Canada
Canada Mortgage and Housing Corporation
Canada Customs and Revenue Agency
Statistics Canada

Netherlands

De Nederlandsche Bank

United Kingdom

Bank of England
Council of Mortgage Lenders
HM Treasury
Inland Revenue
Office of the Deputy Prime Minister
Professor ADH Crook, Pro Vice Chancellor and Professor of Town and Regional Planning, University of Sheffield
Professor P Kemp, Director of the Social Policy Research Unit, and Professor of Social, University of York

United States

Census Bureau
Department of Housing and Urban Development
Fannie Mae
Federal Reserve Bank of New York
Federal Reserve Board of Governors
Internal Revenue Service
Professor Michael Schill, Wilf Family Professor of Property Law and Professor of Urban Planning and Director, Furman Center for Real Estate and Urban Policy, New York University