# RBA ECONOMICS COMPETITION 2008

*Housing Costs and Affordability in Australia*

## First Prize


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Following recent rises in official interest rates, there has been much focus in the popular media on the rising costs of housing. Housing affordability affects the entire economy, not just those individuals who are struggling to pay their housing costs. When households are forced to allocate a high proportion of their income to housing costs, it reduces consumer demand for other items and may even reduce the supply of labour in certain areas where housing costs are high (Yates 2008).

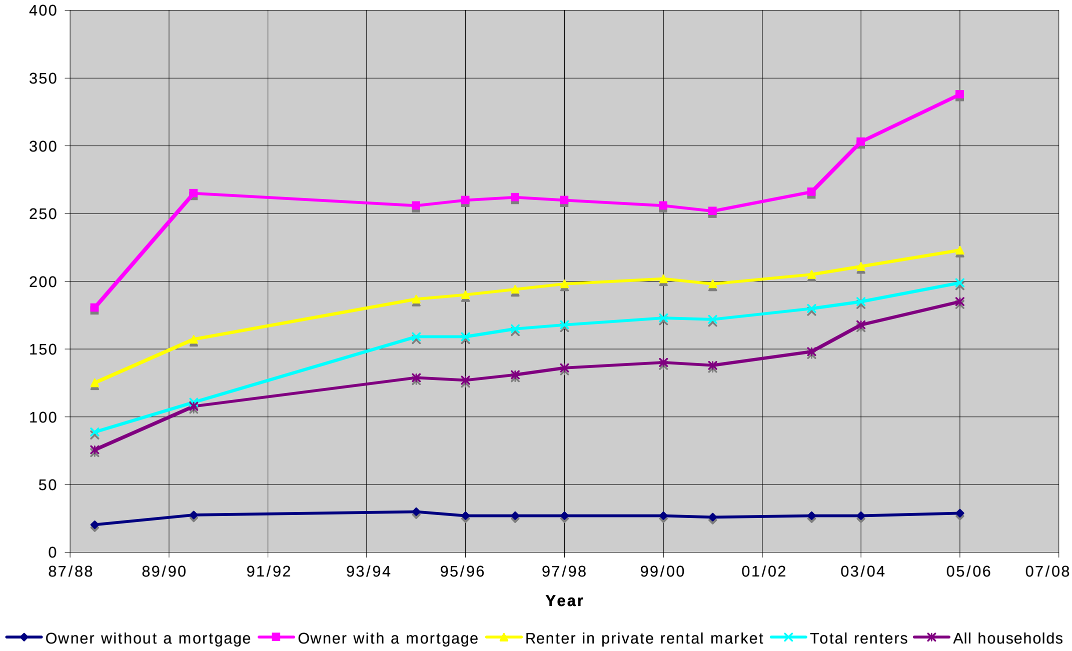
In this article the trends in housing costs and affordability are analysed and the reasons for these trends are discussed. Low-income renters are identified as the type of households most likely to suffer from the negative effects of housing stress. Equity implications of housing trends and possible future developments are discussed and a number of possible policies are outlined.

*Trends in housing costs and affordability*

Whilst popular media has a tendency to focus on the problems of owners with mortgages it is important to consider the housing costs of households with all types of tenure. Owners or purchasers can be divided into those who own their dwelling outright and those who have a mortgage. The majority of renters rent in the private market. In Australia, the amount of housing provided by the state is quite small (Berry and Hall 2006).

**Figure 1**

**Average housing costs (2006$) for households of various types of tenure over time**




*Source:* Based on data from the Australian Bureau of Statistics 1991, 2007.

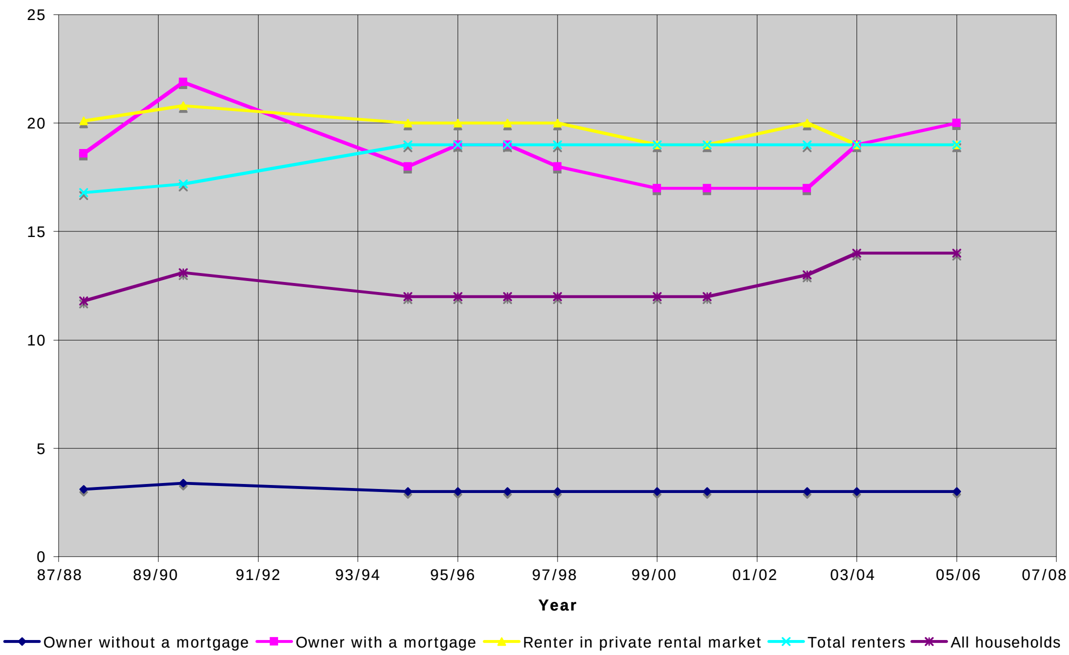
Figure 1 displays the trends in real housing costs by tenure type over the past twenty years. With the exception of owner occupiers without a mortgage, all types of households have experienced a marked increase in average housing costs over this period. The data for owner occupiers without a mortgage indicate that their average housing costs remained relatively constant. Renters appeared to experience a steady increase in average housing costs. After a sharp increase in the late eighties, owner occupiers with mortgages experienced a period of constant or even occasionally declining average real housing costs until 2000/01 after which this groups' average real housing costs began to climb relatively steeply again.

In contrast to these observations, the average proportion of household income spent on housing costs did not appear to increase dramatically for any tenure type. This is primarily because average real household incomes also increased over the period. The average proportion of income spent on housing for owner occupiers remained relatively constant, decreased slightly for private renters and increased slightly for renters overall. This proportion was more volatile for owner occupiers with a mortgage, than for any other tenure type. It peaked in 1990 but had declined by

1994/95. It appears to be on the rise again at the end of the data set having begun to increase from 2002/03. For households overall the proportion appeared to remain relatively consistent until 2000/01 after which it began to rise slowly. It appears that this was primarily due to the rise for owner occupiers with a mortgage.

**Figure 2**

**Average proportion of household income spent on housing costs for households of various types of tenure over time**




*Source:* Based on data from the Australian Bureau of Statistics 1991, 2007.

Whilst the trends in average housing costs provide an initial sketch of housing affordability in Australia over time, they do not provide the whole picture. It is often those at the lower end of the income spectrum who suffer most when their housing costs rise and yet if they are a small group, they do not affect the averages much. According to the Productivity Commission (2004), median rents as a proportion of households' income were relatively stable at the time the report was produced but at the lower end of the market, shortages in affordable rental housing for low-income households were becoming more severe. In line with the privatisation of government enterprises, the amount of public housing has decreased. Some households that would previously have been eligible for public housing are now expected to find accommodation in the private rental market but there has not been an increase in the supply of low-cost private rental housing.

The nationwide averages also fail to account for the fact that the housing market is segmented by location, housing type and quality (Productivity Commission 2004). Although there are some spill over effects between market segments, "an increasing proportion of low cost dwellings are in non-metropolitan areas or in the outer regions of large cities" (Yates 2008).

*Housing Stress*

According to the latest census data, over 1.2 million Australian households are in housing stress[1] (Yates 2008). Marks and Sedgwick (2008 p216) found that renters are far more likely to suffer from housing stress than owners. Between 2001 and 2006 approximately 23-25% of renters were in housing stress compared to approximately 5-7% of owners. The difference was particularly pronounced when the households were divided into income quartiles. Amongst the renters and the owners, the lower the income quartile, the higher the proportion of households in housing stress but in the lowest income quartile for owners approximately 9-11% of households were in housing stress compared to approximately 40-47% of the lowest income quartile of renters (refer to appendix 1). Marks and Sedgwick (2008, p219) found that renters who are in housing stress, tend to remain in housing stress longer than purchasers and that between 2001 and 2006 approximately half of all households that are experiencing housing stress in any given year are no longer in housing stress the following year.

The amount of stress a household experiences from spending a given percentage of their income on housing costs depends on a variety of household characteristics. In general, higher income households suffer fewer negative effects from spending 30% or more of their income on housing costs than lower income households and often higher income households who spend 30% or more of their income on housing are choosing to do so (Marks and Sedgwick 2008).

These observations indicate that policy makers should focus their efforts on low-income renters in the private rental market.

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[1] Housing stress is defined as spending 30% or more of gross household income on housing costs.

*Reasons for housing cost increases*

The determinants of housing costs vary by tenure type but are interrelated. The housing costs of owner occupiers without a mortgage are relatively low compared to other tenure types because they have already paid for the dwelling itself and only need to pay subsidiary ongoing costs. In addition to the subsidiary costs, owner occupiers who have mortgages have mortgage repayments which depend primarily on the initial price of the house, the initial size of the mortgage and interest rates.

Real house prices in Australia have been increasing for several decades (Marks and Sedgwick 2008) and increases were particularly rapid between 2000 and 2007 (Yates 2008). Richards (2008) suggests several reasons for this increase in real housing prices. On the demand side of the market these included the long period of economic prosperity, falling inflation and interest rates, favourable treatment of investment in housing by the tax system and changes in the financial sector leading to an increased availability of mortgage finance. On the supply side of the market Richards (2008) concludes that the main factor is the price of land, which is influenced by the inelastic supply of land in desirable areas such as near major cities or near the water and constraints imposed on the development of land near urban fringes.

The Productivity Commission (2004) suggests that demand side factors have been the greater influence in pushing up house prices since 1990. They note that "(s)ince 1990, reductions in nominal interest rates have roughly doubled the amount that households can borrow for housing from a given income. Innovations in home lending have simultaneously made it easier for many households to access finance and lower real interest rates have made both owner occupied and rental housing more attractive as an investment" (Productivity Commission 2004, p41). Real incomes also increased. The greater amounts of money available for the purchase of houses drove up house prices above that which population growth would predict. In the last decade some purchasers based their decisions on the size of mortgage they could afford at the low level of interest rates that have prevailed during this decade, however, "by the end of 2007 standard variable mortgage rates had risen to 8.55%, low by the standards of the previous 25 years but well above average for this decade" (Marks and Sedgwick 2008). This increase in interest rates has continued into 2008, causing some borrowers, particularly marginal ones, to have to cut back their spending in other areas.

Rental rates are influenced by the cost of supplying rental properties and the demand for rental properties. The cost of supplying rental properties is generally dependant upon the same factors as the housing costs of owners with mortgages. Rental yields on residential properties were quite low early this decade (Productivity Commission 2004, p196-197). “Data from the 1986, 1996 and 2001 censuses show an upward shift in the distribution of rental stock towards higher rent properties and also show that higher income households have displaced lower income households from more affordable housing in the private rental market” (Yates 2008, p202).

*Equity implications of higher housing costs*

There are a number of equity implications regarding the current trend in housing affordability. It has become increasingly difficult for those with low incomes to find housing that is both affordable and meets their needs (Productivity Commission 2004). As house prices rise, those who own a dwelling become wealthier, whereas those who don’t will find it more difficult to purchase a property in the future. As rents rise, renters (a significant proportion of which have lower incomes) become worse off, whilst landlords (who usually have high incomes) benefit (Richards 2008). The concern is that as housing costs rise, the gap between the wealthy and the poor will increase. As is apparent from figures 1 and 2, owning one’s dwelling outright provides much insulation against the rising costs of housing. This points to the potential for a generational divide to emerge. As housing costs rise, younger generations who are yet to purchase a dwelling are at a disadvantage compared to older generations (Richards 2008).

*Look to the future*

Several factors suggest that housing affordability may be a greater problem in the future. Marks and Sedgwick (2008) suggest that the reason households have been able to cope with increased housing costs is that the Australian economy is strong. The Intergenerational Report (Treasury 2007, p9) predicts that growth in real GDP per capita will slow in the future as the population ages. The finite supply of land near major cities will continue to be a problem in the long run even if the opening up of extra land for development improves the supply situation in the medium term (Productivity Commission 2004). Yates (2008) notes that various deregulation and privatisation policies may have increased the risk that housing affordability problems will arise for individuals. The deregulation of labour markets means that household incomes are less secure than previously and now that people are more responsible for their own retirement incomes, households are at greater risk of suffering from increased housing costs after retirement, particularly those who have been unable to purchase and pay off a home during their working life.

To some extent, if housing becomes increasingly expensive, people may adjust their housing preferences. Currently most Australians display a strong preference for detached houses. As desirably located land becomes increasingly scarce, households might relax their preferences and change their housing expectations.

*Possible Policies*

Government intervention in the housing market carries a number of risks. Giving more money to spend on the purchase of housing or rent, especially on a large scale, can result in house prices (Richards 2008) or rental rates increasing in the long run. According to Yates (2008), "(m)ost effective long-run solutions to housing affordability problems lie in addressing the underlying determinants of demand and supply." She asserts that the government is unlikely to be able to influence any of the major drivers of demand for housing and should focus on the supply side of the market rather than on subsidising the demand side of the market. The Productivity Commission (2004) asserts that demand side subsidies tend to increase prices.

A variety of sources indicate that low-income renters in the private market are most at risk of suffering from housing affordability problems and these households should be the primary focus of housing policies. Capping the rent of certain dwellings can have negative side effects including excessive demand for these apartments and landlords doing a poor job of maintaining the dwelling.

Desirable regions such as inner city areas have seen a higher rate of growth in land prices than other less desirable regions such as the city fringes. Land in inner city regions is usually inelastically supplied (Yates 2008). Changing zoning areas in inner suburbs of major cities to allow denser housing development would provide more housing stock in these desirable areas on the same amount of land.

Encouraging more people to live in the city fringes may also be effective in reducing overall housing costs. Decreasing land taxes or increasing affordable public transport in these areas may help achieve this objective (Yates 2008). However, unrestricted opening up of land for development could cause urban sprawl problems. To prevent this, rather than indiscriminately opening up land for development, it might be prudent to encourage development of denser affordable housing around transport 'hubs'.

Providing concessions or subsidies to the development of and investment in modest, affordable rental housing might help to increase its supply. These could take the form of exemptions from the various development and land taxes usually associated with new developments.

The government already has policies in place that affect the housing market. For example, stamp duties are charged on the purchase of dwellings. Whilst they only account for a small proportion of the cost of purchasing a home, they prevent the efficient allocation of the housing stock (Productivity Commission 2004). Stamp duties create a transaction cost large enough to make it difficult for households to downsize when their circumstances change. They also provide an extra obstacle to first home buyers attempting to save a deposit. However, they provide substantial tax revenues to the States so their removal would cause a number of problems. First home buyers are given concessions from stamp duty by the majority of states whilst the ACT runs an income test (Productivity Commission 2004). Perhaps these concessions could be extended to those households who wish to downsize because they are experiencing severe mortgage stress. Applicants would have to meet several conditions to help to prevent this system being abused. An income test would be appropriate and the percentage of the household income being spent on housing costs would have to have increased dramatically, perhaps from under 20% at the time the mortgage was taken out to above 40%.

The Productivity Commission (2004) provides a number of strong arguments for changing or removing the First Home Owner Scheme. They find that beneficiaries of this scheme usually have above average incomes and would end up purchasing housing within a short period of time, even without this aid. Those households who are at the greatest risk of housing stress are private renters, not purchasers and perhaps this money could be better redirected to aid them. As an alternative to removing it entirely, the Productivity Commission suggests limiting the First Home Owner Scheme, "to those purchasing homes priced below regionally differentiated price ceilings" (Productivity Commission 2004, p220).

*Conclusion*

Over the past two decades real housing costs have risen. This rise has been partly offset by the increase in real household incomes and is likely to continue. Increasing house prices have been one of the primary drivers of this increase and house prices themselves are influenced by a variety of factors. Rising housing costs may lead to an increasing gap between the wealthy and the poor as time goes on. Low-income renters are most at risk of suffering negative effects due to rising housing costs and hence the first policy priority should be to assist these types of households. A variety of policies has been suggested.

# Appendix 1

Occurrence of housing stress in Australian households between 2001 and 2006

| **Tenure type and income quartile** | **Percentage of households in housing stress each year** | | | | | |
|---|---|---|---|---|---|---|
| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
| **Owners** | | | | | | |
| Lowest | 10.9 | 11.2 | 10.2 | 10.3 | 8.6 | 10.8 |
| 2nd | 5.5 | 4.9 | 6.8 | 7.2 | 8.8 | 8.8 |
| 3rd | 2.9 | 3.1 | 2.7 | 3.9 | 5.0 | 6.5 |
| Highest | 1.8 | 2.0 | 2.3 | 2.5 | 3.2 | 4.3 |
| **Overall** | **5.3** | **5.4** | **5.6** | **6.1** | **6.4** | **8.1** |
| **Renters** | | | | | | |
| Lowest | 47.2 | 46.0 | 41.8 | 47.3 | 43.2 | 40.4 |
| 2nd | 16.0 | 14.2 | 16.9 | 13.4 | 11.6 | 14.0 |
| 3rd | 3.3 | 6.4 | 5.5 | 3.7 | 3.4 | 3.9 |
| Highest | 1.5 | 2.7 | 2.6 | 0.4 | 1.9 | 0.9 |
| **Overall** | **23.9** | **24.4** | **25.3** | **24.8** | **24.3** | **23.1** |

*Source:* Marks and Sedgwick 2008, p216-217.

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