Australian Government
Productivity Commission

First Home Ownership

Productivity Commission Inquiry Report

No. 28, 31 March 2004

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The Productivity Commission, an independent agency, is the Australian Government's principal review and advisory body on microeconomic policy and regulation. It conducts public inquiries and research into a broad range of economic and social issues affecting the welfare of Australians.

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31 March 2004

The Hon Peter Costello
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

In accordance with Section 11 of the *Productivity Commission Act 1998,* we have pleasure in submitting to you the Commission's final report on *First Home Ownership*.

Yours sincerely

Gary Banks	David Robertson	Edward Shann
Presiding Commissioner	Associate Commissioner	Associate Commissioner

Declaration of interests

The Commissioners on this inquiry either own or are paying off their own homes and in one case, a holiday house. None has a financial interest in a rental property. Dr Shann's share portfolio includes relatively small holdings in Becton Developments Ltd and Watpac Ltd. He has no other direct investments in property-related companies.

Terms of reference

PRODUCTIVITY COMMISSION ACT 1998

I, PETER COSTELLO, Treasurer, pursuant to Parts 2 and 3 of the *Productivity Commission Act 1998*, request that the Productivity Commission undertake an inquiry to evaluate the affordability and availability of housing for first home buyers.

Recognising that home ownership is very highly valued by families and individuals, and is central to social and family stability, for the purposes of this evaluation the Commission should:

- Identify and analyse all components of the cost and price of housing, including new and existing housing for those endeavouring to become first home owners;
- Identify mechanisms to improve the efficiency of the supply of housing and associated infrastructure; and
- Identify any impediments to first home ownership, and assess the feasibility and implications of reducing or removing such impediments.

Particular attention should be given to the following matters as they affect the cost and availability of residential land and housing in both metropolitan and rural areas:

(a) the identification, release and development of land and the provision of basic related infrastructure;

(b) the efficiency and transparency of different planning and approval processes for residential land;

(c) the efficiency and transparency of taxes, levies and charges imposed at all stages of the housing supply chain;

(d) the efficiency, structure and role of the land development industry and its relationship with the dwelling construction industry and how this may be affected by government regulations;

(e) the effect of standards, specifications, approval and title requirements on costs and choice in new dwelling construction; and

(f) the operation of the total housing market, with specific reference to the availability of a range of public and private housing types, the demand for housing, and the efficiency of use of the existing residential housing stock.

The inquiry will also identify and examine mechanisms available to improve the ability of households, particularly low income households, to benefit from owner-occupied housing. This will include an assessment of rent and direct ownership subsidies, loan guarantees and shared equity initiatives.

In undertaking the inquiry, the Commission is to invite public submissions, consult with key interest groups and affected parties, issue a draft report, and produce a final report of its findings by 31 March 2004.

PETER COSTELLO
[Reference received 4 August 2003]

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Abbreviations

ABA	Australian Bankers’ Association
ABCB	Australian Building Codes Board
ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ACOSS	Australian Council of Social Service
AHURI	Australian Housing and Urban Research Institute
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
AWU	Australian Workers’ Union
BCA	Building Code of Australia
CAG	Commonwealth Additional Grant
CBD	Central Business District
CFMEU	Construction, Forestry, Mining and Energy Union
CGT	Capital Gains Tax
CoAG	Council of Australian Governments
CRA	Commonwealth Rent Assistance
DCP	Development Contribution Plan
DIMIA	Department of Immigration and Multicultural and Indigenous Affairs
DSP	Development Servicing Plan
FHOG	First Home Owner Grant
FHOS	First Home Owner Scheme
GST	Goods and Services Tax
HIA	Housing Industry Association
IC	Industry Commission

IGA	Intergovernmental Agreement
IMF	International Monetary Fund
IPART	Independent Pricing and Regulatory Tribunal (NSW)
LVR	Loan-to-valuation ratio
MBA	Master Builders Australia
NAHP	National Affordable Housing Project
NCOSS	Council of Social Service of NSW
OECD	Organisation for Economic Co-operation and Development
PC	Productivity Commission
PCA	Property Council of Australia
Pers. comm.	Personal communication
PIA	Planning Institute of Australia
RAIA	Royal Australian Institute of Architects
RBA	Reserve Bank of Australia
REIA	Real Estate Institute of Australia
RIS	Regulatory Impact Statement
Sub.	Submission
Trans.	Transcript
UDIA	Urban Development Institute of Australia
VCAT	Victorian Civil and Administrative Tribunal

Key findings

- Fluctuations in prices and 'affordability' are inherent features of housing markets.
- The upswing in housing prices since the mid-1990s has been bigger and more widespread than in previous cycles.
  - Notwithstanding lower interest rates, housing 'affordability' has declined considerably in the past two or three years.
- Rising house prices indicate that demand has been outstripping supply.
  - Much of this increase in housing demand has been due to cheaper, more accessible finance and buoyant economic growth through the 1990s.
  - This led to higher prices because of inherent limitations on the responsiveness of housing supply to surges in demand, particularly as much of the demand came from existing home owners seeking to 'upgrade' in established areas.
- Only in the last couple of years have house prices surpassed levels that are explicable on this basis, with some additional investment seemingly predicated on unrealistic expectations (in a 'supportive' tax environment) of ongoing capital gains.
- To the extent that currently low housing affordability reflects cyclical price pressures, this will eventually be reversed. (Evidence of market cooling is already emerging.) However, there is a role for policy to address forces that can cause prices to be excessive over the entire housing cycle.
- Interactions between negative gearing, 'capital works' deductions, post-1999 capital gains provisions and marginal income tax rates have lent impetus to investment demand during the housing boom.
  - These influences are not confined to housing and selective 'fixes' could have ramifications across the economy. Potential reforms need to be assessed through a broader review, with a focus on capital gains provisions.
- Reducing reliance on stamp duties would help first home buyers and improve the efficiency of housing markets over time.
- There is also scope to moderate price and affordability pressures over time by:
  - improving land release and planning approval processes; and
  - ensuring that developer charges for infrastructure relate appropriately to the benefits provided to home buyers in new housing developments.
- The First Home Owner Scheme, though conceived to compensate for the GST, would have more impact on home ownership if better targeted at lower income households.
  - But the funds may generate larger social benefits if used to address the broader housing needs of the lowest income Australians, which should be the subject of a separate public review.

Overview

Owning a home is of fundamental importance to most Australians and we have among the highest rates of home ownership in the world. The 'family home' brings many people a sense of security and belonging, and home ownership generates wider benefits for a nation's 'social capital'. A house is also the most valuable asset that most people acquire in their lifetimes and accounts for around two-thirds of all private sector wealth in Australia. A house is therefore both a home and an investment.

It follows that most Australians have an abiding interest in house prices. When prices rise sharply, as they have done since the mid-1990s, existing home owners — around 70 per cent of Australian households — benefit from increased wealth. But the new generation of aspiring first home buyers can find it more difficult to realise their dream. Because housing markets are inherently cyclical, concerns about first home affordability arise periodically. Against the backdrop of especially rapid price growth in recent years, the possibility that home ownership may be moving out of reach for many has prompted the Government to initiate this public inquiry.

The terms of reference are wide-ranging, but they essentially comprise three questions:

- What has happened to affordability for first and other home buyers in recent years?
- What have been the major causes of changes in affordability?
- Are government policy initiatives warranted to improve affordability or the efficiency of housing markets generally?

Within the time available to it, the Commission has sought to bring a broad perspective to these issues, encompassing the demand and supply sides of the housing market, distinguishing structural from cyclical influences, and assessing policy according to the implications for the community as a whole.

Box 1 Some observations about housing markets

- Houses are assets that provide an ongoing stream of 'consumption' and investment services. Prices reflect expectations about the future value of these services, as well as current market conditions.
- Housing prices — and especially the value of the land on which they are sited — fluctuate considerably over time, partly as a result of slow supply responses to periodic surges in demand. Also, price rises (or falls) can condition expectations about the future. 'Overshooting' can result, with booms followed by busts.
- In Australia, since 1996, average house prices have more than doubled in nominal terms and risen by around 80 per cent in real terms — over half of this in the last three years.
- Housing markets are diverse and comprise many different segments, based on location, housing type and quality. The market can also be divided into rental and owner-occupied components.
- While price pressures inevitably flow across market segments, differences can persist. For example, in both Sydney and Melbourne, real prices over the past decade have actually fallen in some suburbs, while increasing by as much as 15 per cent a year in others.

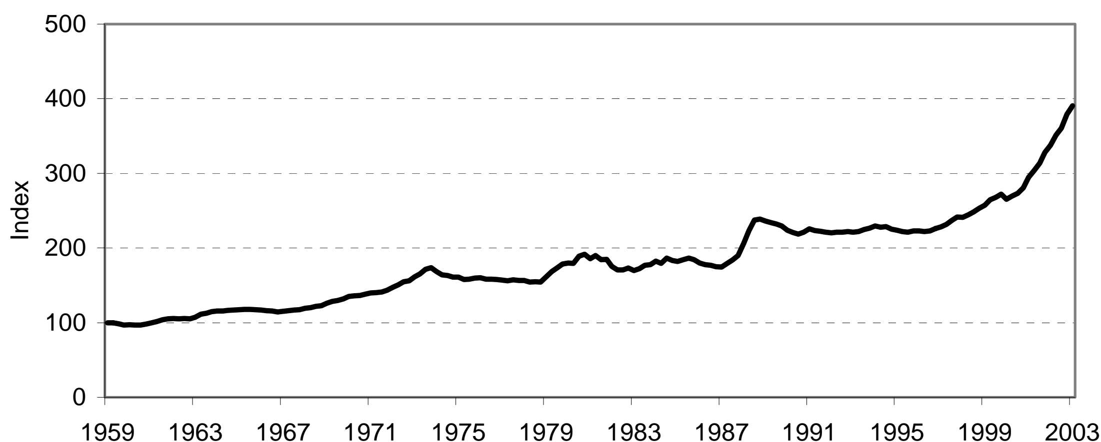
What has happened to 'affordability'?

While Australia has experienced periods of more rapid growth in house prices, the escalation in prices since the mid-1990s has been more prolonged and cumulatively greater than in previous upswings (see figure 1). It has also been more widely spread. Price rises largely began in the more expensive suburbs of Sydney and Melbourne, but over time spread across these and other capital cities, as well as to many regional centres. Unlike the booms in the early-1970s and late-1980s, the recent upswing has not extended to commercial property.

This price growth has meant that the median house price in Australia is now equal to 9 times average per capita income, compared to 6 times at the beginning of the upswing. This is much higher than at the peak of the last boom and also appears high by international standards.

However, the 'affordability' of home ownership at a point in time depends not just on house prices and income levels, but also on the cost of finance, which fell dramatically in the 1990s. As a consequence, during the recent upswing, the various published indexes all show affordability to be stable or improving until the last couple of years, when further steep price rises occurred.

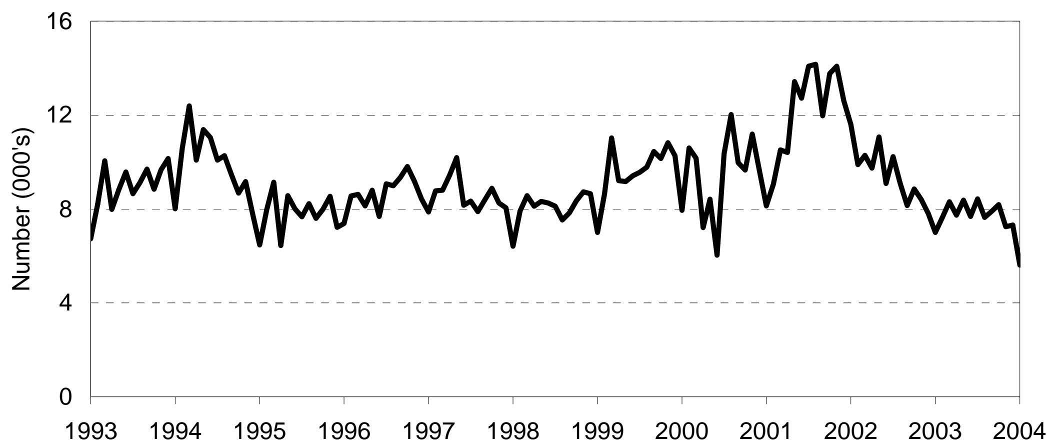
Figure 1 **Real house price growth in the long term**



While 'measured' affordability has declined considerably in the most recent years — generally and for first home buyers — it is unclear where it stands historically. Notwithstanding their popular usage, the available indexes all suffer from methodological and data problems that preclude precise conclusions, particularly concerning first home buyers. In the Commission's view, the most that can be said is that affordability in parts of Australia is now near, if not below, the low levels of the late 1980s, when inflation and interest rates were very high.

Another possible indicator of what has happened to affordability is home ownership rates. These are currently estimated at nearly 70 per cent (as a proportion of all households), which is high by international standards. While ownership rates have fallen somewhat since the 1980s, they appear to have stabilised during the first part of the boom (to 2001). This is consistent with improvements in measured affordability in that period, resulting from rising incomes and falling mortgage rates. Moreover, the previous decline in home ownership was largely concentrated in the younger age brackets, possibly because many Australians have been entering the workforce and starting families later. Detailed ownership data are not yet available for the last couple of years, when house prices rose sharply. However, the surge in investment in rental housing may be indicative of further reductions in ownership rates in this latest period.

Figure 2 **Monthly loan approvals for first home buyers**



Much has been made of the recent decline in the share of new housing loan approvals accounted for by first home buyers. However, at least until very recently, this seems to have been the result of strong growth in demand by investors and change-over buyers, and some earlier 'pull-forward' of first home purchases to qualify for the additional temporary subsidy to first home buyers of new dwellings. The underlying trend in the number of first home buyer approvals has been flat over the past decade (see figure 2), though a continuation of the most recent decline would change that.

Box 2 **Who are the 'first home buyers'?**

- The majority of first home buyers are aged in their twenties and thirties, with the average age remaining at around 33 over the past decade.
- Most first home buyers are couples, though the proportion of lone-person households buying a first home has increased by 50 per cent since 1990.
- The majority of first home buying households have above-average incomes, with over 55 per cent reporting gross weekly incomes in the top two income quintiles in 2000-01. Though this share has changed little from a decade earlier, a growing proportion of the households buying their first home have two or more incomes.
- More first home buyers are purchasing townhouses and apartments (20 per cent in 2000-01 compared to 12 per cent a decade earlier). They are also purchasing fewer new dwellings (20 per cent in 2000-01 compared to 26 per cent in 1994).
- First home buyers rely heavily on debt finance — in the three years to 1999, the average deposit paid was 10 per cent of the purchase price. Of those paying a deposit, nearly 80 per cent had saved it themselves.

Why have prices risen so fast?

A story of demand and supply

Surging house prices clearly signal that demand has been outstripping supply. It is important in seeking the causes, therefore, to consider the factors influencing both sides of the market. This was a matter on which participants expressed a variety of views. Some emphasised the role of demand forces, whereas others argued that constraints on the ability of supply to respond were the main problem. The different diagnoses led to different suggested remedies.

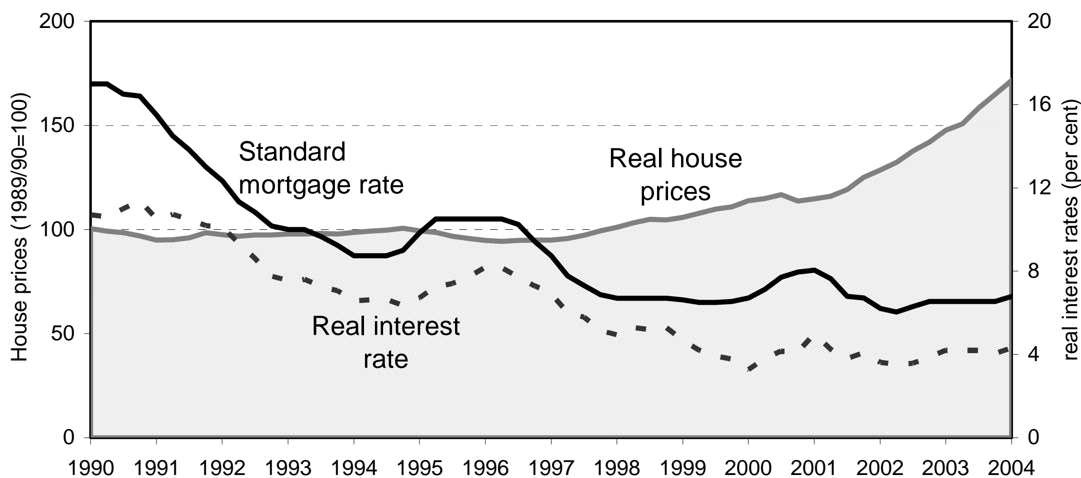
In the Commission's view, both sides of the market have contributed to observed outcomes. However, the *dominant* source of the widespread escalation in prices has been a general surge in demand — above the normal increases associated with population and income growth — to which supply was inherently incapable of responding, at least in a way that could moderate the pressure on prices in the short term. There are several elements to the explanation.

'Easy money' a key driver

Cheaper and more accessible housing finance is a central part of the story. With inflation under control, interest rates fell through much of the 1990s and, in recent years, have been about half their levels of a decade earlier (see figure 3). At the same time, greater competition among housing lenders (including the advent of mortgage originators and brokers) has made it much easier to obtain loans, and has contributed to lower interest costs by reducing lending margins.

For owner occupiers, a halving of the interest rate almost doubles the mortgage potentially obtainable, as well as nearly doubling the price of a home that can be 'afforded' for a given budget or income. With double the purchasing power, existing home owners could choose to 'trade-up' to an improved (bigger, nicer, better located) house, and aspiring first home owners could buy sooner. This didn't happen overnight, because decisions about moving home take time and depend on a family's circumstances. But the cumulative response to lower finance costs was a growing demand for housing, most of it not from first home buyers. To the extent that interest rates remain relatively low and finance readily accessible, a large part of the recent shift upward in prices will be permanent.

Figure 3 **Falling interest rates**



At the same time, lower (real) interest rates and expectations of rising house prices encouraged greater investment in rental properties, much of it by existing owner occupiers:

- The proportion of taxpayers with an investment property has almost doubled in the past decade, reaching nearly 17 per cent in the most recent survey.
- In the same period, investment loans as a proportion of new loan commitments have grown from around 20 to more than 40 per cent (see figure 4), with investment loans now accounting for one-third of banks' total loans outstanding.

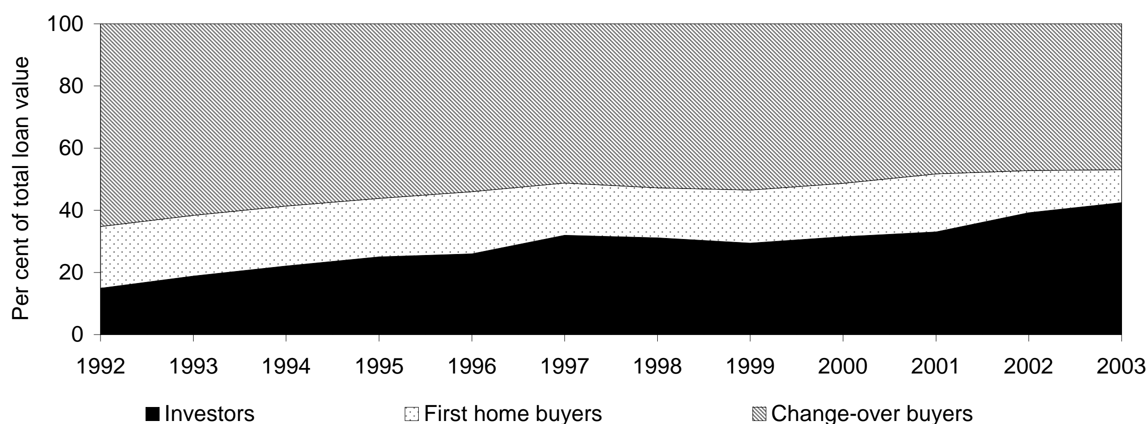
The investor-driven component of demand for housing was further stimulated by the downturn in the share market from 2000 to early 2003; by a 'supportive' tax environment (see below); and by aggressive marketing of housing investment 'opportunities'.

Economic growth contributed

A fundamental determinant of housing affordability in the long term is *income*. As people's incomes grow, they generally spend proportionately more on housing. Since the early 1990s, real average household income has increased by just over 1 per cent a year; the number of people in full-time jobs has grown by over 900 000 and, in aggregate, real household disposable income has risen by about 30 per cent.

The implication is that, in addition to the effects of cheaper and more accessible credit, a sizeable proportion of the burgeoning demand for housing has come from higher incomes and more jobs — in short, economic growth.

Figure 4 **Housing finance commitments by type of borrower**



Note. Excludes refinancing of established dwellings.

Other demand-side influences have been longer term

The major determinants of the underlying growth in demand for additional dwellings are population growth and the propensity of people to form households. Both have played a significant longer-term role, but do not explain the surge in demand and prices since the mid-1990s.

- While immigration has grown rapidly in this period, it has been partly offset by a slower rate of natural increase in the resident population, so that the overall rate of population growth has been relatively stable. That said, immigration has been an important contributor to underlying demand growth, especially in Sydney and Melbourne. (In Brisbane, migration from other parts of Australia has been the major contributor.)
- A trend to smaller households, including a rise in single occupancy, has also increased underlying demand for housing. But this is a long-term phenomenon predating the recent boom. (The average number of people in a 'household' has fallen from 4.5 in 1901, to 3.3 in 1971, and 2.6 in 2001.)

But there were some recent 'boosters'

A feature of the upswing in prices since 1996 is the 'second wind' it appeared to receive in the last few years. Apart from the stock market downturn, noted previously, two other developments are relevant on the demand side.

- One was the boost to demand provided by the First Home Owner Scheme, which in compensating for the GST has injected an additional $4.3 billion into the

housing market over the past three and a half years. However, its overall effect on prices has been relatively small.

- The second was the September 1999 change to capital gains taxation, from a real to a 'discounted' nominal basis. This heightened the attraction for individuals of investing in property in a period of strong house price growth and low inflation, reinforcing other demand-side pressures.

Why couldn't supply keep up?

Cheaper, more readily available housing finance in a booming economy, with some added policy stimulus, has resulted in a prolonged surge in demand. Borrowing for housing has increased over four-fold in real terms since the early-1990s.

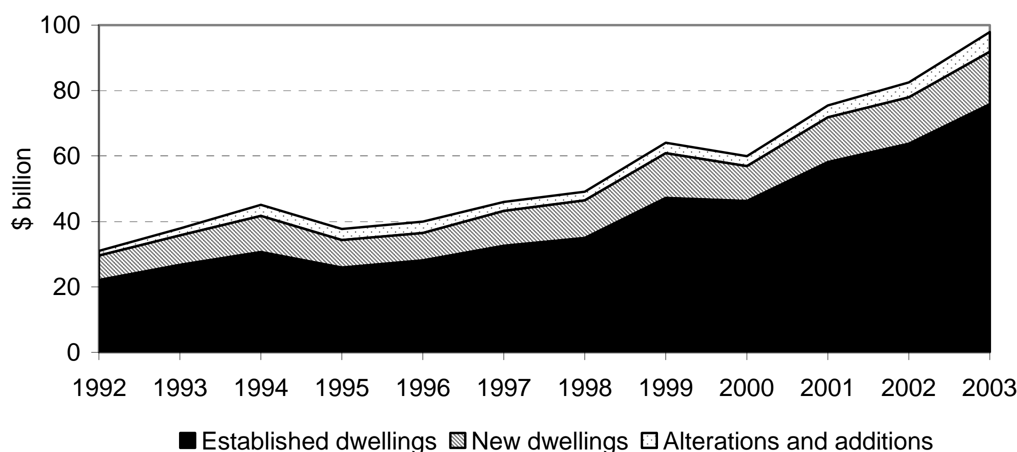
In most markets, such an increase in demand would have had an initial impact on prices, but this would soon have induced extra supply, moderating price outcomes over time. So why hasn't this happened in the housing market? The short answer is that, apart from any regulatory hindrances, the supply of housing is *inherently* constrained from responding quickly to sudden demand pressures.

- Even in a best-practice supply chain, it can take several years to bring new land on-stream, to provide the associated infrastructure and to construct new dwellings.
- But even if this were not so, there would have been major price pressures in the recent cycle, because much of the surge in demand came from people seeking to upgrade their dwellings (mainly in established areas) in response to increased purchasing power. Even if only a small proportion of households attempt to buy a higher quality or better located home, the price of all housing is soon bid up.

Over the past decade, borrowing by owner occupiers for existing dwellings has increased at more than double the rate of borrowing for new dwellings (see figure 5). Indeed, new housing sales (including at the urban fringe) have rarely accounted for more than 2 per cent of the housing stock, compared to average housing turnover of 6 to 8 per cent a year.

That is not to suggest that governments could not make supply more responsive (see below). However, in order to accommodate a general surge in demand, actions would need to be focused on the more desirable established suburbs, where higher density development is not feasible on a large scale and, even if successful, would not necessarily meet the preferences of many of those seeking to upgrade.

Figure 5 **New finance commitments for owner-occupied homes**



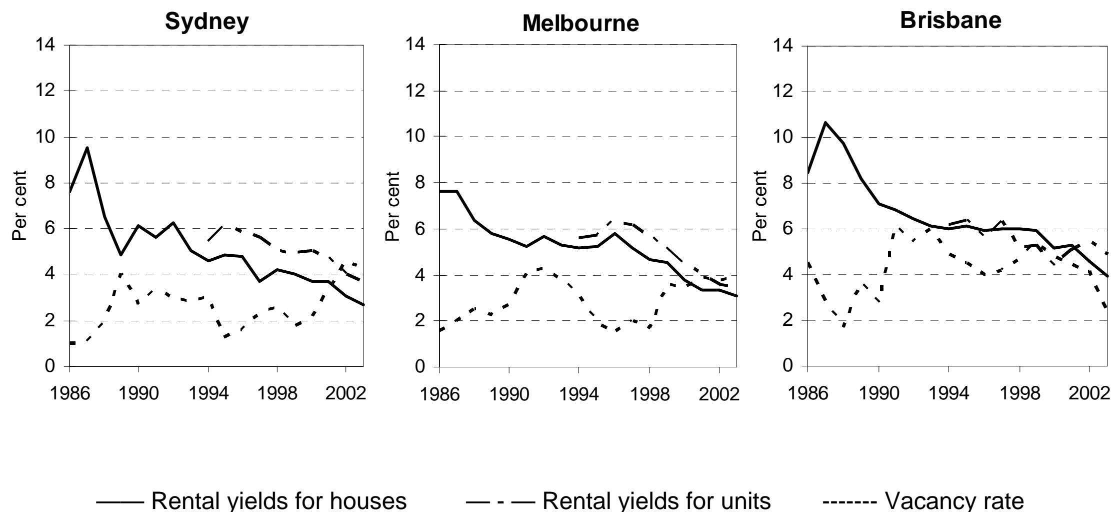
Have prices 'overshot'?

Various fundamental influences on the demand and supply sides of the market explain much, but not necessarily all, of the recent growth in house prices — especially in the last couple of years. In an asset price boom, rising prices can create expectations of further price increases unrelated to any change in market fundamentals. Inherent features of the housing market — such as lagged supply responses — make it particularly prone to 'overshooting'. One recent international study concluded that property price booms were three times more likely to be followed by a 'bust' than booms in the stock market. Price falls can be substantial, as Australian experience attests.

It is difficult to determine with precision whether house prices are 'appropriate' at any point in time, especially given the diversity and segmentation within housing markets. However, some basic indicators on the investment side of the market suggest that overshooting has occurred, even allowing for the effects of taxation provisions (discussed below). For example:

- rental yields on residential property — and the implicit rental benefits of owner-occupied housing — have fallen well below their long-term averages in most of the capital cities (see figure 6);
- the rate of growth in the price of apartments has been comparable to the rate of increase for detached dwellings, despite lesser land requirements; and
- vacancy rates, especially for apartments, have risen, suggesting that supply has more than caught up with demand in this segment (with more supply on the way).

Figure 6 **Rental yields and vacancy rates in three capital cities**



—— Rental yields for houses — - — Rental yields for units ------- Vacancy rate

Note. Rental yield is calculated as the median annual rent as a proportion of the median dwelling price.

Taken together, such indicators raise doubts about the sustainability of current prices — especially in market segments such as inner-city apartments.

A presumption of continuing and strong appreciation in house prices appears to have been driving market outcomes. Yet realistic expectations about income and population growth, or other ongoing drivers of housing demand, cannot support a continuation of recent price growth. Moreover, recent interest rate rises, the likelihood of some catch-up in supply, and improved returns to investment in the stock market, all point to a softening of short-term price pressures.

There is already evidence of market cooling. For example, recent months have seen the cancellation of several proposed high-rise projects, reduced auction clearance rates across the board, a substantial drop in lending for housing, and a marked deceleration in average house price growth in Sydney and Melbourne, with price falls in some market segments.

What should governments do?

This assessment suggests that there is limited scope for governments to improve affordability for first (and other) home buyers in the short term.

- Sustained growth in household incomes and cheaper and more accessible housing finance have been of considerable benefit to the community generally, notwithstanding their effects on house prices and first home buyers.

- The apparent overshooting in the market will be addressed by cyclical price adjustment. Though disadvantaging those who have recently purchased homes, such a market correction (together with further income growth) will in due course improve affordability for prospective first home buyers.

However, governments do have an important role to play in facilitating efficient housing outcomes. In particular, policy initiatives to address any structural factors that encourage excessive demand for housing, or that unnecessarily reduce the responsiveness of supply to increases in demand, will reduce 'average' house prices over future cycles and could provide enduring affordability benefits to both home buyers and renters.

Would tax changes help?

Taxation arrangements can have direct and indirect effects on house prices and thus on affordability. However, the economic incidence of any given tax is not easy to determine and rarely equates with the statutory obligation to pay it. Thus, the burden of taxation on housing — and especially housing-specific taxes — will generally be shared between the buyer and the seller, regardless of who initially pays.

While the impacts of taxes such as the GST and stamp duty cannot be determined precisely, increased taxation has not been responsible for much of the recent escalation in house prices. For example, though stamp duty revenue has increased strongly as a result of rising house prices and higher turnover, it remains a relatively small proportion of the price of a house.

Even so, stamp duties are a hurdle for households endeavouring to save a deposit for their first home. They also inhibit the efficient reallocation and adaptation of the housing stock. Reducing reliance on stamp duties could thus be expected both to improve the efficiency of housing markets over time and, depending on how it is financed, facilitate home ownership.

Of course, moving in this direction would not be straightforward:

- reliance on stamp duties, and therefore the revenue that would need to be raised through more efficient alternative tax instruments, varies across jurisdictions (but it is substantial in all);
- various administrative and transitional issues would need to be addressed were stamp duty revenue to be replaced by, for example, wider application of land tax or by reducing payroll tax concessions and exemptions; and
- there could also be implications for Commonwealth–State financial arrangements.

The Commission does not see these as negating the potential benefits of reform, but rather as highlighting the importance of a carefully managed approach. Reform could be undertaken by each jurisdiction individually, although Commonwealth–State implications would be best addressed in a joint forum.

RECOMMENDATION

The coverage of the review to be held by 2005 under the 1999 Intergovernmental Agreement on the reform of Commonwealth–State financial relations, should be extended to include consideration of how best to reduce stamp duties on property conveyancing. In particular, the review should examine the scope to replace stamp duty revenue with more efficient forms of taxation or sources of revenue.

Stamp duties can apply to sales already subject to GST. Moreover, because stamp duty can be collected more than once as a property changes hands, GST can also sometimes apply to stamp duty-inclusive sales. There are likely to be efficiency gains from reducing such tax-on-tax anomalies, particularly if stamp duties are likely to continue for some time.

RECOMMENDATION

If the 2005 intergovernmental review (or another mechanism) does not lead to reduced stamp duties on property transactions, a further forum should assess the potential gains from addressing property-related 'tax on tax' and 'multiple tax collection' issues.

Various aspects of the personal taxation regime also have an impact on expenditure on housing and therefore on house prices and affordability. For instance, established home owners are advantaged by the exemption of the principal residence from capital gains tax and the non-taxation of 'imputed' rental income from owner-occupied dwellings — potentially leading to over-investment in housing.

However, it is unclear that there would be large gains to the community from changes to promote tax 'neutrality' in relation to owner-occupied housing, given the administrative complexities and compliance costs, and the possible loss of social benefits from home ownership that would follow. Equally, it would not be desirable to extend existing tax preferences through, for example, allowing owner occupiers to claim tax deductions for mortgage interest costs.

Other aspects of the personal taxation regime — including negative gearing rules, 'capital works' deductions for buildings, the 1999 change to capital gains tax for assets held by individuals, and high marginal income tax rates — have combined to magnify the attractiveness of investing in residential property during the recent upswing in house prices, thereby adding to price pressures.

It needs to be emphasised that these features of the income tax system do not in principle favour private investment in rental housing over other passive investments, such as in the stock market or commercial property. Investors in these areas can also benefit either directly or indirectly, from the same negative gearing and CGT arrangements, and the same allowable deductions. The fact that these provisions, like many others in the tax system, may have different *effects* across asset classes is not in itself a matter for policy concern.

Nonetheless, aspects of those provisions, particularly the CGT arrangements, appear to have 'pro-cyclical' effects that potentially distort investment flows whether into housing or other asset classes. Attempting to address these impacts for housing alone would be hazardous. Indeed, ostensibly 'quick fixes' suggested by many participants — such as limiting negative gearing or removing the CGT discount for housing — could detract from rather than promote more efficient investment. Hence, the Commission considers that a broader examination is needed.

RECOMMENDATION

The Australian Government should, as soon as practicable, establish a review of those aspects of the personal income tax regime that may have recently contributed to excessive investment in rental housing. The focus of the review should be on the Capital Gains Tax provisions. However, it should also assess 'second best' options for addressing distortions in incentives to invest in housing and other asset markets, including: restrictions on negative gearing and changes to the capital works deduction provisions for buildings. Pending such review, it would not be appropriate to make housing-specific changes to negative gearing rules or to capital gains tax arrangements.

Could supply be made more responsive?

As noted, there are inherent constraints on the capacity of housing supply to respond to surges in demand in a way that could greatly moderate price rises. That said, in many parts of Australia, it appears that regulatory processes could work better to facilitate a more responsive housing market.

Most governments have sought to limit the outward expansion of their capital cities, in order to reduce infrastructure costs and protect the environment. In doing so, the scarcity value of land in those cities will inevitably rise. Unless there are offsetting increases in housing density, affordability will be adversely affected. Indeed, there is evidence that constraints on the supply of land at the urban fringe have added to price pressures, particularly in Sydney.

These trade-offs call for strategic planning processes in which the benefits and costs of different long-term options for the evolution of cities, and the assumptions and estimates that underpin them, can be publicly discussed and tested. It is not evident that all jurisdictions have adequately met these requirements in relation to the future supply of residential land.

RECOMMENDATION

All state and territory governments should have long-term land release strategies that are based on extensive public scrutiny of projections and key assumptions. The trade-offs between greenfield development and urban consolidation should be a particular focus of such processes.

While state and territory governments directly influence what land is potentially available for the construction of dwellings, decisions about what development is permissible and where, are generally made by local governments. The planning approvals process is thus critical to the timely and appropriate expansion and reshaping of cities.

Box 3 Examples of reforms to planning approval processes

- *Pre-lodgement certification* — in Victoria, procedures have been developed aimed at ensuring that applications meet the information requirements of the approval process from the outset.
- *Fast-tracking approvals* — in South Australia, the Minister can now identify a ‘major development’ (of social, economic or environmental significance) for fast-track approval, in which merit appeals, judicial review and civil enforcement are removed.
- *Integrated approvals process* — the NSW Government has introduced a single point of contact for developers to obtain the separate applications required by different referral or approval bodies.
- *Outsourcing assessments* — a number of councils, including Leichhardt, Woollahra and North Sydney, have trialled private sector involvement in planning approval assessments on a fee-for-service basis, in order to speed up the process and overcome skill shortages.
- *Alternative dispute resolution* — new mechanisms to resolve disputes early in the planning approval process include the Independent Hearing and Assessment Panel (Liverpool City Council, Fairfield City Council) and facilitation committees (Gosford City Council).
- *Speeding up court hearings* — in South Australia’s Environment, Resources and Development Court a compulsory conference provides an opportunity for parties to an appeal to resolve differences before proceeding to a hearing.

The overwhelming view put to this inquiry by those involved in seeking development approvals is that the processes are deficient and have become increasingly so — and that this has contributed to the recent escalation in house prices. The views of local and state governments have varied, but their actions in initiating reviews and making some changes to planning approval processes (see box 3) indicate recognition that things can be done better.

The combination of state-based reviews (such as Victoria's 'Better Decisions Faster') and the work of the Development Assessment Forum (see box 4) at the national level, provides an important opportunity for informed debate and assessment of potentially useful reforms. Indeed, these reviews are better placed than this broader national inquiry to assess in detail the problems in different jurisdictions and to develop specific options for addressing them. Nevertheless, in the Commission's view, the four areas identified below deserve particular attention in carrying forward various proposals and directions for reform emerging from these reviews.

RECOMMENDATION

State and local governments need to give priority to the scope to:

- ***achieve greater separation of policy making and administration;***
- ***streamline permit approval processes to enable minor or uncontentious developments to by-pass unnecessary informational or consultative requirements;***
- ***improve or expand 'as of right' development provisions, without detracting unduly from the property rights of existing residents; and***
- ***reduce delays in appeals while maintaining the protections of due process.***

As participants' responses to the Discussion Draft illustrate, there are no single or uncontentious solutions in any of these areas. In each of them, a core issue is the extent to which clear rules, with broad community support, can be established.

There will inevitably be an element of 'experiment' in any initiatives adopted to improve regulatory processes. And community standards can change over time. This underlines the importance of not only subjecting any new proposals to adequate testing and scrutiny, but also of conducting periodic reviews to assess the performance of those that are implemented. It also cautions against seeking to impose uniform national approaches before outcomes have been assessed. This in turn highlights the importance of having mechanisms to enable best practice to be communicated across jurisdictions on an ongoing basis.

Box 4 The work of the Development Assessment Forum (DAF)

The DAF was established in 1998 for the purpose of identifying ways to streamline development approval processes. It comprises representatives from the Australian, state, territory and local governments, the development industry and related professional associations. Following a recent review, drawing on a report by the Centre for Developing Cities, it has recommended the following 'leading priorities' for planning policies and processes (elaborated in chapter 6):

1. Separation of policy development from planning approval roles.
2. Technically excellent assessment criteria.
3. A single point of assessment for development applications.
4. Independent, expert assessment and review panels.
5. Appeals dealt with by a second expert assessment panel, against the same criteria.
6. Third party involvement limited to initial policy input.
7. Private sector involvement in specified compliance assessment roles.
8. Assessments streamed into tracks related to complexity and impacts.
9. Built-in feedback mechanisms to improve processes over time.

Could industry perform better?

The land development, detached housing and building materials industries appear broadly efficient and competitive. While some land developers may have a degree of market power in certain areas, other developments, existing housing and the potential entry of new developers, limit the scope for overpricing.

However, productivity levels in the commercial (high-rise) residential building sector are lagging behind its counterparts in several overseas countries, as well as being considerably below those in the detached housing sector. There is scope to improve work practices in the commercial sector. This could be especially helpful in reducing the costs of raising the density of urban areas. An effective regulatory framework is important in facilitating improved work practices.

Notwithstanding past policy initiatives, apparent shortcomings have re-emerged in the way building regulations in Australia are developed, raising questions as to whether the benefits always outweigh the costs. Better use of regulatory impact assessments would help allay such concerns.

Are infrastructure charges too high?

Government strategic planning and controls on development can be justified on the basis that some of the social costs and benefits of locational decisions, such as environmental impacts, are not reflected in prices faced by home buyers. However, a problem with relying on such supply-side controls is that they may not adequately account for community preferences. One benefit of a progressive shift to 'user pays' systems for infrastructure services, is that it should in time reduce the extent to which prescription is necessary to determine where new development can occur. However, no reduction in prescription has been evident to date.

The housing and development industries have further argued that charges on developers for infrastructure have become excessive or are being inappropriately levied. Considerable potential savings for home buyers from better charging practices have been claimed.

There is a strong case for users of infrastructure services paying for costs attributable to them. A charge on users, if it represents the true costs of supply, ensures that demand is not excessive and resources are not wasted. As noted, it also promotes efficient locational choices for housing development. The real issues relate to how to apportion the costs among users and over time. In the Commission's view:

- Upfront charging for infrastructure should not in principle reduce affordability relative to equivalent payments over time, although in practice more marginal borrowers will be disadvantaged if lending institutions do not adjust their maximum loan-to-income rules.
- It is appropriate that the cost of 'basic' infrastructure contained within a particular development — and of predominant benefit to prospective home owners — is borne initially by the developer and included in house prices.
- For 'major' infrastructure shared among developments, where the incremental costs can be well established and vary across locations, there is also a good case for apportioning its costs according to use.
- However, where benefits are provided in common to users across the community, there is a stronger case for funding such investments out of general revenue sources. This is especially relevant to most 'social' infrastructure, such as community recreation facilities and open space, the costs of which in some jurisdictions are increasingly being borne upfront by developers.

RECOMMENDATION

Investments in items of social or economic infrastructure that provide benefits in common across the wider community should desirably be funded out of borrowings and serviced through rates, taxes or usage charges.

While current charging practices do not always conform to these requirements, inappropriate or excessive charging is unlikely to account for a large proportion of existing developer charges. Moreover, developer charges have generally increased less than house prices. In any case, the burden of any excessive charging for infrastructure, being akin to a tax, would tend to fall most heavily on owners of undeveloped land. By the same token, any subsidised provision of new infrastructure would primarily benefit land owners or developers rather than home purchasers.

Nonetheless, widespread compliance with some general charging principles would help to promote more efficient and equitable outcomes.

RECOMMENDATION

Developer charges (and charging for infrastructure generally) should be:

- ***necessary — with the need for the services concerned being clearly demonstrated;***
- ***efficient — justified on a whole-of-life cost basis and consistent with maintaining financial disciplines on service providers by precluding over-recovery of costs; and***
- ***equitable — with a clear nexus between benefits and costs, and only implemented after industry and public input.***

Developer charges are more likely to satisfy the above principles if the processes for establishing and applying them are sound and transparent. Further, efficiency would be enhanced if charging regimes provide developers with some flexibility in the timing of developments and in the design of the infrastructure.

RECOMMENDATION

Authorities and utilities imposing developer contributions and charges should:

- ***follow guidelines based on the principles set out in the two previous recommendations, and be subject to independent regulatory scrutiny;***
- ***provide for 'out of sequence' development if developers are prepared to meet the cost consequences;***
- ***be open to proposals for alternative infrastructure arrangements that meet the needs of the households concerned;***
- ***allow appeals on the amounts charged, or their coverage; and***
- ***be accountable for how money raised from charges is spent.***

A case for direct assistance?

The Commission was asked to assess various direct measures to assist people to achieve home ownership, particularly low-income households. A variety of such measures currently exist, most notably the First Home Owner Scheme (FHOS). Many new measures have been suggested, including proposals for 'shared-equity' and 'lifeline' schemes canvassed for the Home Ownership Taskforce.

Assistance to promote home ownership needs to be predicated on the social benefits outweighing the costs. However, with ownership rates already high in Australia (most Australians attain home ownership sometime in their lifetime), and with the more recent affordability problems being partly cyclical, the case for support beyond what is already available through the tax system is not compelling. In particular, while the FHOS was conceived as compensation to first home buyers for the introduction of the GST, its ongoing justification in this role is questionable. The money involved could yield a higher return to the community if redirected to support the broader housing needs of low income households.

In the course of this inquiry, the Commission has heard that many low income households in rental markets, or in public (or community) housing, face significant problems in getting access to affordable or adequate housing. While some participants have argued that such problems should be addressed in detail in this inquiry, the Commission is of the view that an inquiry with a focus on first home ownership could not do justice to the broad-ranging issues involved. Rather, they deserve separate review.

RECOMMENDATION

A national public inquiry should be established to examine the housing needs of low income households across Australia, including in Indigenous communities, and the nature and extent of assistance to help meet those needs.

If governments wish to continue providing direct assistance to first home buyers, the current FHOS provides an administratively simple and flexible basis for delivering the bulk of such assistance.

However, a deficiency in the present arrangements, reflecting the initial compensation rationale, is their limited targeting. The bulk of FHOS assistance goes to households with above-average incomes, who might otherwise have purchased a house before too long, even without assistance. In the Commission's view, the scheme would have a greater impact on first home ownership if it were more closely targeted at lower income households, with a commensurate increase in grant levels.

RECOMMENDATION

If the First Home Owner Scheme continues:

- ***assistance should be targeted to the housing needs of lower income households by restricting eligibility to homes below (regionally differentiated) price ceilings; and***
- ***there should be a commensurate increase in the average size of the grant.***

As in the case of the FHOS, it is unclear whether various other assistance measures that have been proposed to assist first home buyers would yield significant benefits. Nor is it clear that such proposals would be preferable to a targeted FHOS.

A shared equity arrangement of the sort considered by the recent Home Ownership Taskforce would effectively allow for the purchase of part of a home and may therefore make 'ownership' more accessible for lower income households. The test of the viability of this approach is whether the home lending market can develop products which are attractive to both borrowers and lenders. Given the likely complexity of shared-equity arrangements, the case for government 'seed' money or ongoing support is not compelling.

'Lifeline' assistance designed to help households cope with short-term financial stress, as also suggested by the Home Ownership Taskforce, involves administrative complexities and its impact on home ownership is uncertain. In any case, there are already mechanisms in place for this purpose and the case for government funding for a new scheme is weak.

Concluding comments

Housing markets are large, diverse and interactive. There are many players on both sides of the market, and pervasive government influence at all levels. And there are strong cyclical as well as structural influences on market outcomes. Prices periodically rise and fall, and such price movements can vary across market segments.

In the Commission's view, there is no 'quick fix' to address affordability concerns. Indeed, governments cannot prevent most of what happens to house prices and should not try. Nevertheless, there is scope for governments to increase the efficiency of housing markets and thereby to improve price and affordability outcomes over time. This report points to several areas where action appears warranted.

A number of these areas are complex and some have ramifications beyond the housing market. In this short inquiry, it has not been feasible or appropriate to undertake the detailed assessments (and public testing) of specific policy responses to such wider problems. This report explains why change is needed and indicates directions for reform in these areas, as well as recommending changes in some housing-specific policies. It thus provides a foundation for reforms that should be of lasting benefit to the community.

1 About the inquiry

1.1 What has the Commission been asked to do?

For most Australians, home ownership is a major goal. Nearly 70 per cent of dwellings in Australia are owner occupied, and it has previously been estimated that as many as 90 per cent of people attain home ownership at some stage of their lives. The 'family home' is also the most significant asset that most people acquire in their lifetimes and accounts for two-thirds of private sector wealth in Australia.

Over the past few years, housing prices around Australia have risen sharply. This has made it more difficult for some prospective first home buyers to enter the market.

The possibility that home ownership may be moving out of reach for an increasing number of young people and low income households prompted the Australian Government to set up this inquiry. While the terms of reference — which are set out at the front of this report — are broad ranging, they can be synthesised into three questions:

- What has been happening to affordability for first and other home buyers?
- What have been the major causes of changes in affordability?
- Are government policy initiatives warranted to improve affordability, or to improve the efficiency of the housing market more generally?

In examining possible policy initiatives, the terms of reference ask the Commission to identify any impediments to first home ownership, and to assess the feasibility and implications of reducing or removing such impediments. The Commission is also asked to examine mechanisms to improve the ability of households, particularly low income households, to benefit from owner-occupied housing. Hence, the inquiry has provided an opportunity to review the effectiveness of existing measures to assist first home buyers, as well as to examine the sorts of proposals raised in reports prepared for the recent Prime Ministerial taskforce on home ownership (see Bor and Moloney 2003; Caplin and Joye et al. 2003; Gans and King 2003).

1.2 How has the Commission approached its task?

A community-wide perspective

The Commission has framed its assessments of housing affordability and related policy settings in terms of what will deliver the best outcomes for the Australian community over time. This is in keeping with the general approach to policy analysis embedded in the Commission's legislation.

Within this community-wide framework, and consistent with the terms of reference, the Commission has had regard for the wider social benefits of home ownership (see box 1.1). Acknowledged benefits, such as greater social stability and improved health and educational outcomes, help to explain why the Australian and state and territory governments provide considerable support for home ownership. The basic requirement that all members of the community have access to affordable housing means that distributional issues also loom large in policy formulation.

However, it is important to recognise that affordable rental housing also provides social and distributional benefits. Indeed, because of the additional flexibility that rental accommodation can offer, most people will prefer to rent during at least part of their lives. Also, for many aspiring first home owners, a period of renting will be necessary to accumulate a housing deposit.

Hence, policies to assist home buyers must have regard to any costs imposed on those in private rental accommodation (or in public or other forms of community housing). Moreover, policies to promote and support home ownership can also have wider economic and social costs which must similarly be included in the policy calculus. For example:

- Such policies will inevitably see more of the community's resources invested in housing, and less in other, possibly more productive, activities.
- Where support involves subsidies or tax concessions, there are costs for taxpayers and/or potential beneficiaries of alternative government programs.
- Increased investment in housing can have negative social or environmental effects: concerns about the adverse consequences of urban sprawl on the one hand, and higher density living on the other, are two examples.

Beyond some point, these costs will outweigh the additional benefits for the community, meaning that the pursuit of ever increasing levels of home ownership would not be a sound policy objective. As a number of inquiry participants from the social welfare sector observed, home ownership will always be beyond the reach of some low income individuals and families, with other forms of government

assistance, such as public housing and rent assistance, being more effective ways to support their housing needs.

Box 1.1 **The social benefits of home ownership**

Access to affordable and quality housing is central to community wellbeing. Apart from meeting the basic need for shelter, it provides a foundation for family and social stability, and contributes to improved health and educational outcomes and a productive workforce. Thus it enhances both economic performance and ‘social capital’.

While many of these social benefits will be provided by affordable, high quality rental housing, some studies (eg Rohe et al. 2000; Glaeser and Shapiro 2002) indicate that they tend to be larger for home ownership. For example:

- Because the value of their homes are directly affected by what happens in the surrounding community, owner occupiers are likely to have stronger incentives than renters for civic involvement.
- Home ownership provides greater security of tenure, reinforcing incentives for community participation. Less frequent relocation also minimises disruption to established social networks and children’s education.
- By giving occupiers more control over their living space, home ownership can enhance self esteem, in turn reducing the incidence of socially disruptive behaviour and promoting physical wellbeing. In this latter regard, recent Australian research by Waters (2002) suggests that home owners have better health than equivalent renters. And, the Australian Association of Social Workers (trans., p. 352) said that home ownership can promote better access to disability and aged services.

Further, the Housing Industry Association (sub. DR260, p. 7), amongst others, contended that home ownership can reduce the extent of welfare dependency later in life. In effect, the underlying argument is that home ownership is a form of ‘forced’ saving which, like superannuation, can subsequently be drawn on as an alternative to welfare payments.

Such social benefits provide a rationale for governments to facilitate home ownership. In Australia, governments provide various tax concessions to owner occupiers and first home buyers (chapter 5). Also, they directly subsidise purchases by some home buyers (chapter 10). This support is in addition to the provision of public housing and rent assistance for low income households, and the exclusion of the family home from the pension assets test.

However, the magnitude of the social benefits is very difficult to establish. Moreover, government support for home ownership is not without costs for others in the community (see text). Hence, the efficacy of specific measures to encourage home ownership will ultimately depend on whether the induced social benefits are greater than the accompanying costs (chapter 10).

The implication is that the community's interests will be served by policy settings that deliver a level of ownership where the social benefits and costs are approximately equal for the 'marginal' home owner. Consistent with this objective, the Commission has sought to identify initiatives that would both improve affordability for first home buyers — thereby facilitating home ownership — and enhance, or at least not detract from, overall community welfare.

Understanding what underlies changing affordability

At face value, the 'affordability' of home ownership is the product of house prices, the cost of housing finance and income levels.

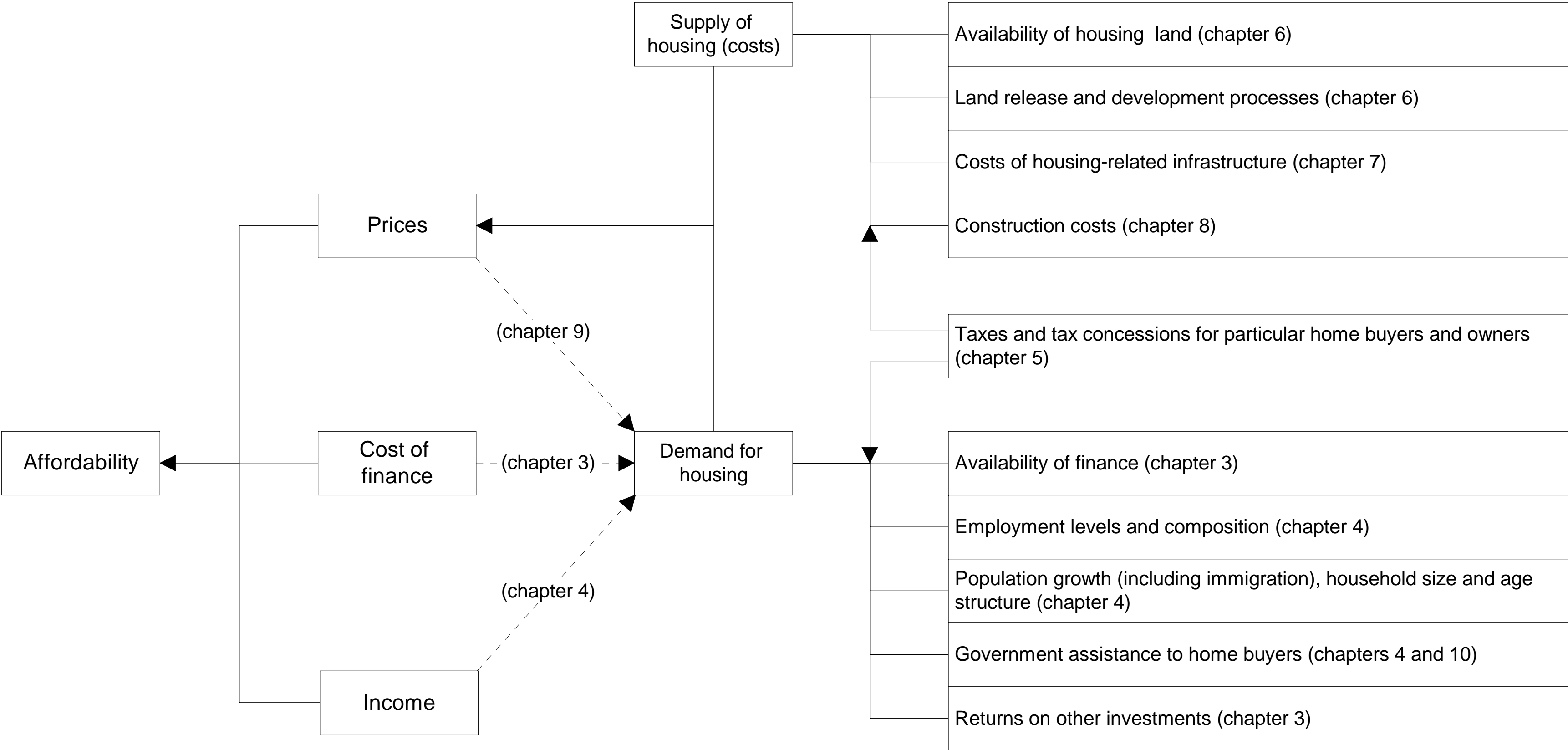
But underlying this ostensibly simple concept is a complex set of forces (see figure 1.1):

- House prices are the net outcome of various determinants of the demand for housing and the cost of supply.
- Some demand and supply factors are cyclical in nature, with their effects felt primarily in the short term. Others are 'structural' and influence prices over the medium to longer term.
- While the determinants of house prices can be categorised according to whether their initial impact is on demand or supply, the ultimate price effects will depend on how the two sides of the market interact. For example, the less responsive is supply, the greater will be the price rises ensuing from an increase in demand for housing.
- Income levels and the cost and availability of finance will have feedback impacts on the demand for housing over time, as well as affecting affordability at a point in time. In addition, the expectations generated by price rises may themselves fuel further rises — the so called 'bubble' phenomenon.

Some other features of the housing market which make the analysis of prices and affordability more complex are discussed in box 1.2.

What is clear, however, is that in virtually all countries house prices fluctuate considerably around long-term trends. In combination with (often related) changes in the cost of housing finance, this means that housing affordability also fluctuates. Not surprisingly, calls for additional support to assist first and low income households to purchase homes are most evident during periodic low points in the affordability cycle.

Figure 1.1 **Multiple determinants of housing affordability**



Box 1.2 **Some distinctive features of the housing market**

The housing market has some distinctive features which are relevant to the analysis of price trends and affordability.

The nature of the asset

- The price of a 'house' represents the combined value of the dwelling and the land on which it is sited. Most of the change in house prices reflects changes in the value of land. (In this report, except where price data refer specifically to detached houses, the term 'house prices' is used generically to encompass all types of residential dwellings, including the land.)
- Houses are assets that provide an ongoing stream of consumption and investment services. Hence, the price of a house will implicitly reflect the discounted 'present value' of that stream of services and depend on expectations about future demand and supply, as well as current market conditions.

Price volatility

- While house prices in most countries tend to rise over time, prices also fluctuate considerably, with 'overshooting' sometimes leading to booms and busts.
- The cyclical nature of housing demand is responsible for much of this price fluctuation. Most house purchases are financed by debt, making demand sensitive to movements in interest rates and access to finance, as well as to income and employment trends. And investment in rental housing is influenced by the returns available on alternative investments such as equities, which similarly fluctuate over time.
- Other factors also contribute to price volatility and overshooting:
  - Short-term constraints on the responsiveness of supply make it difficult to accommodate cyclical surges in demand. It can take several years to transform raw housing land to a construction-ready state (including the supporting infrastructure). There are also constraints on infill development and on the upgrading of the existing housing stock.
  - 'Indivisibility' and the high search and other transactions costs associated with buying and selling houses make them much less liquid assets than, say, equities. This can delay and thereby accentuate adjustments to changing market conditions. Similarly, depending on their family circumstances, households may take years to vary their housing requirements in response to changes in prices, incomes and borrowing costs.

(continued next page)

Box 1.2 **(continued)**

Most transactions involve turnover of the existing housing stock

- The availability of housing land in cities and towns is typically limited. In combination with other previously noted constraints on supply, the result is that new dwellings augment the housing stock by at most 2 per cent a year. In contrast, each year, 6 to 8 per cent of the existing stock is bought and sold. This has two important implications for this inquiry:
  - Rapid growth in demand for an asset stock that can only be expanded slowly will almost inevitably lead to increases in the value of housing land, and therefore to higher house prices — particularly in premium locations.
  - In analysing price and affordability issues, it is necessary to look at impediments which discourage turnover of existing dwellings — for example, stamp duties — or upgrading of dwellings, as well as at constraints on augmentation of the stock.

Segmentation of the market

- Within the overall housing market, there are many different segments. The market is split geographically, by dwelling type and by price/quality bands. It can also be divided into owner-occupied and rental housing. However, such submarkets are not unconnected, with substitution occurring across them in response to changes in relative prices and rental yields. The linkages between market segments in turn mean that:
  - Even though the majority of first home buyers may be purchasing in particular submarkets, prices in those markets and hence affordability are influenced by broader market trends.
  - Initiatives to help first home buyers will have implications for other home buyers, as well as for those in rental accommodation.
- Diversity within the overall market also raises the question of what prices should be used to assess affordability. Moreover, analyses of affordability trends should ideally account for changes in the nature and composition of the housing stock over time as preferences change.

It is also evident that some of the drivers of recent house price increases and/or declining affordability, are not of policy concern or even amenable to policy intervention. For example, cheaper and more accessible finance, income growth and low returns on non-housing investments have been important contributors to the recent housing boom (chapters 3 and 4). And, depending on how it is measured (chapter 2), the apparent decline in affordability over the long term may partly result from the collective decisions of households to spend a greater share of their incomes on housing.

Hence, in looking at how to improve housing affordability, the Commission has sought to identify factors or policy settings that unnecessarily or inappropriately inflate house prices. These could include, for example:

- unrealistic expectations on the part of purchasers about future price increases;
- tax or subsidy arrangements that encourage excessive demand for housing; or
- artificial or unnecessary regulatory constraints on additions or improvements to the housing stock in response to increased demand.

The scope to address such impediments to greater affordability has in turn been a consideration in the Commission's assessment of the case for direct government assistance to promote home ownership.

A focus on priority issues

In the limited time available for this inquiry, it would not have been possible for the Commission to address comprehensively each of the many influences on house prices and affordability. Indeed, some such as urban planning, land release arrangements and the taxation of housing, could reasonably be (and have been) the subject of major inquiries in their own right.

Accordingly, the Commission has focused its attention on:

- what seem to have been the key drivers of recent increases in house prices, with emphasis on demand and supply factors (and any associated policy settings) that have recently changed; and
- policy initiatives likely to deliver *significantly* better outcomes for aspiring first home buyers and the wider community over time.

In looking at these matters, the Commission has been cognisant of the role that public housing and Commonwealth rental assistance can play in assisting some low income households to eventually achieve home ownership. For example, several inquiry participants contended that public housing has provided an important stepping stone to ownership in parts of Australia and in some other countries. Also, to the extent that public housing augments the total housing stock, it can serve to contain price pressures in the broader market — and especially for the sort of properties likely to be most accessible for aspiring low income first home buyers. However, time constraints and the focus of the inquiry on affordability for those purchasing houses, precluded examination of the many more general (and important) issues attaching to public housing and Commonwealth rental assistance raised by participants.

Similarly, the Commission has not explored the possible role of regional policies in making home ownership more affordable. Such policies may well help to alleviate housing pressures in the major cities and thus improve affordability for those living there. On this basis, in its response to the Discussion Draft, the Victorian Government (sub. DR301, p. 8) contended that the Commission had '… omitted consideration of an important option to help first home buyers enter the housing market'.

However, as discussed in box 1.3, benefits for home buyers in the major cities if more people could be induced to live in regional areas, would most likely come at the cost of reduced affordability for those already residing in these regional areas. Moreover, as several inquiry participants pointed out, housing affordability will be just one of many considerations in formulating effective regional policies. Indeed, the Victorian Government's suggestions for complementary policy initiatives in areas such as higher education and immigration to encourage people to move to regional locations where housing costs are lower, illustrates why proper assessment of the whole area is beyond the purview of this inquiry. (No other government submissions took issue with this aspect of the Commission's approach.)

Finally, to avoid duplication of effort, the Commission has drawn heavily on the large body of previous Australian and overseas work concerned with housing issues germane to the terms of reference. Such studies are referred to throughout this report.

Opportunities for extensive public input

Because of the short reporting period for the inquiry, the Commission sought to streamline and expedite its inquiry processes. Nonetheless, these processes provided the opportunity for a wide range of interested parties to contribute to the Commission's deliberations:

- Shortly after receiving the terms of reference, it released an Issues Paper (PC 2003a) inviting written submissions on the matters under review. Prior to releasing a Discussion Draft (see below) it received more than 220 submissions from a broad cross section of industry, government, financial sector and community interests, including from many individuals.
- During the course of the inquiry, the Commission met with a wide range of organisations and individuals, including: key industry associations; providers of housing finance; the Reserve Bank of Australia; various Commonwealth, state and local government entities; land and property developers; and several academics and research institutions engaged in housing-related research and policy development. Some of these meetings were conducted on an individual

basis, while others took the form of mini-roundtables with particular interest groups.

Box 1.3 Regional policy and housing affordability

Over time, the regions may act as a safety valve if affordability problems in the cities become particularly acute. That is, if a large affordability gap opens up, some people will move to the regions where housing tends to be cheaper. The Victorian Government noted that such movement is already evident:

> Increasing numbers of consumers are … choosing to purchase homes in certain regional centres, and commute to work in the city, find employment locally, or re-settle after self-funded retirement. (sub. DR301, p. 8).

Housing affordability will also influence where those moving from the cities choose to locate. For example, as a result of sharp increases in house prices in many coastal centres, migration from the cities to inland regional areas is becoming more common.

However, whether regional policy should be explicitly targeted at reducing demand pressure on capital city housing markets — as suggested by the Victorian Government and some other participants — is a complex issue that cannot be satisfactorily resolved in an inquiry of this sort.

The likely effects of regional policies on overall housing affordability are difficult to gauge:

- Population pressures have not contributed greatly to the demand surge that has caused affordability in the capital cities to decline sharply over the last year or two (chapter 4).
- While those encouraged to move to the regions may be able to purchase more affordable homes, as is already evident, the additional demand pressure is likely to reduce affordability for aspiring first home buyers already living in those areas.
- Improving transport links from regional centres to the cities may have a role to play in easing housing demand pressures in those cities, but the benefits from improving outer-suburban or city transport may be just as high.

In any event, in some regions, house prices have been rising as fast, or faster, than in the major cities (chapter 2). There would be obvious problems trying to fine-tune regional policies on the basis of housing affordability, especially as those centres with the most affordable housing tend to be less attractive for economic and other reasons.

This in turn illustrates that housing affordability is only one of many considerations in formulating effective regional policies. As past Australian experience illustrates, attempts to encourage people to move to regional areas without proper regard to the full range of economic and social effects can be costly.

- In September 2003, the Commission organised a larger roundtable, attended by some 30 housing experts and major interest groups, to elicit views and discussion on the key issues for the inquiry.

- In December, the Commission released a Discussion Draft (PC 2003b) outlining its initial views and findings. To elicit views on that draft, the Commission held public hearings in Brisbane, Sydney and Melbourne during January and February 2004. Some 37 organisations and individuals participated in discussions at those hearings. The Commission also received more than 100 additional written submissions responding to the preliminary analysis and findings in the Discussion Draft, including from several state governments. And meetings were held with other state and territory governments that did not provide formal written responses.

A full list of those with whom the Commission met, those who made submissions and those who participated in the public hearings, is provided in appendix A. While this report contains only limited explicit references to input from inquiry participants, that input has provided the Commission with an invaluable source of information, data and analysis. Accordingly, it wishes to thank all of those organisations and individuals who contributed to the inquiry.

1.3 Guide to the report

The remainder of this report essentially comprises three parts:

- The first (chapter 2) describes trends in house prices and housing affordability for first home buyers and others. In doing so, it outlines some distinguishing characteristics of the recent housing boom, including the prominent role played by investors.
- The second looks at factors underlying price and affordability trends and at the related policy implications. Specifically, it:
  - describes the important role played by cheaper and more readily available housing finance (chapter 3);
  - examines the main factors influencing demand for housing over the long term, including natural population increase and immigration, and growth in incomes and employment (chapter 4);
  - discusses how aspects of the taxation regime have reinforced demand and price pressures and canvasses the pros and cons of suggested changes to current tax arrangements (chapter 5);
  - assesses whether the supply of serviced land for housing has tightened, and whether augmenting or upgrading the housing stock is becoming a more time-consuming and costly process (chapter 6). Particular attention is given to urban planning, land release and development approval procedures;

- looks at the extent to which higher infrastructure charges have contributed to recent house price increases and whether the basis for setting those charges is appropriate (chapter 7);
- briefly canvasses the performance of the land development and housing construction sectors and examines some particular workforce and regulatory issues that appear to be contributing to price pressures (chapter 8); and
- discusses whether there is an element in recent house price outcomes that cannot be explained by reference to market 'fundamentals' and might thus be indicative that prices have 'overshot' (chapter 9).

- The final part (chapter 10) outlines some considerations germane to the issue of whether direct support for first home buyers is likely to provide a worthwhile return to the community. It also compares different policy approaches for directly assisting first home buyers.

2 Are recent price and affordability trends unusual?

Findings

- Historically, Australian house prices have fluctuated around a rising long-term trend. The 'affordability' of home ownership has also fluctuated — not only because of variations in prices, but also in response to income growth and changes in the cost and accessibility of finance.
- Over the long term, house prices in Australia have been increasing faster than incomes. But the magnitude of the implied 'structural' decline in affordability is unclear. Today's dwellings are much larger and of higher quality than those of yesteryear. Related infrastructure and community facilities are also much improved.
- The recent housing boom has been more prolonged, with cumulatively greater price increases than past upswings, and geographically more widespread. Also, unlike previous booms, it has not extended to commercial property.
- Sharply increased investment in rental housing has been a major contributor to the growth in demand and the ensuing increases in house prices.
- Since the trough in early 1996, the Australia-wide average price for a (detached) house has more than doubled in nominal terms and risen by nearly 80 per cent in real terms. Over half of this increase has occurred in the last three years.
- The commonly reported indexes, while not without deficiencies, collectively suggest that affordability for first home buyers has declined considerably in the past year or two. By some measures, in parts of Australia affordability is now comparable with, if not worse than, in the late 1980s, when inflation and interest rates were very high. Among the capital cities, the decline in measured affordability is greatest for Sydney.
- The situation for those living in rented accommodation is more mixed. Over the past decade, median rents in most parts of Australia have risen broadly in line with average household incomes. But there are also claims that the stock of low-cost rental housing has diminished and that affordability for some low income renters has declined.
- In the 1980s and 1990s, there was some decline in Australia's (relatively high) level of home ownership, particularly among younger age groups. However, demographic, economic and social developments have been shifting the tenure balance towards rental housing. Moreover, (census-based) ownership data are not yet available for the period since 2001. Hence, it is too early to say whether recent declines in affordability have affected home ownership rates.

As noted in chapter 1, house prices and affordability are strongly cyclical. This chapter looks at how the recent housing boom compares with previous market upturns and at its effects on affordability, particularly for first home buyers. To provide a broader context for this discussion, the chapter also provides some long-term price data and a brief overview of the importance of housing to Australia's economic and social fabric.

2.1 A snapshot of housing in Australia

Australians have a strong preference for home ownership. While ownership levels have dropped somewhat since the 1980s (section 2.3), nearly 40 per cent of residential dwellings are fully owned by one or more of the occupants, with a further 30 per cent occupied by households paying off a housing loan.

Traditionally, Australians have also shown a strong preference for detached houses. However, a growing number are now residing in medium and high density dwellings. Indeed, if current trends continued, within 20 years, only around half of all dwellings in Sydney would be detached.

Homes do more than provide shelter; they are also the major store of household wealth (and the major source of household debt). Moreover, the delivery of housing services is an important part of the Australian economy:

- Australia has roughly 8 million dwellings, valued at over $2200 billion (including the land).
- As noted in chapter 1, dwellings account for almost two-thirds of private sector wealth — well above the levels in countries such as the United States and the United Kingdom.
- Housing-related debt similarly accounts for the bulk of total household debt and has been growing in relative importance. For example, lending for housing by banks and other deposit taking institutions ($440 billion at the end of 2003) accounts for some 82 per cent of the total value of their loans to households, up from 65 per cent at the beginning of the 1990s. Much of this increase is due to a sharp rise in the number of owner occupiers who have also acquired investment properties.
- Over the past few years, an average of around 500 000 dwellings have been bought and sold each year. However, turnover fluctuates markedly — tending to rise with upswings in demand. For example, in Melbourne, some 100 000 dwellings changed hands in 2001 compared to just over 50 000 in 1990 and 1991 after the boom of the late 1980s.

- In recent years, an average of just under 150 000 new dwellings have been commenced across Australia each year (though again annual levels fluctuate considerably). Part of the existing housing stock is also renovated or augmented each year. Australia-wide, the residential construction industry generates turnover of nearly $50 billion a year — of which close to $20 billion is spent on maintenance, alterations and additions — and provides jobs for around 310 000 people.

All tiers of government are heavily involved with the housing sector:

- State and territory governments have extensive responsibilities related to: land release and zoning; establishment of charges for (and in some cases provision of) various housing-related infrastructure; and implementation and enforcement of building and related environmental regulations.
- All state and territory governments also provide public housing and, through corporatised state land development agencies, most compete with private firms in the supply of serviced dwelling lots.
- While the housing-related functions of local government vary, they typically include supervision of land development; the administration of associated planning requirements; and the supply of some infrastructure.
- Through the First Home Owner Scheme, the Australian and state and territory governments provided $4.3 billion to more than half a million first home buyers in the three and a half years to January 2004. State and territory governments also administer a range of additional support measures for low income home buyers.
- Various taxes apply to housing, including stamp duty, land tax, the Goods and Services Tax and Capital Gains Tax (chapter 5). However, comprehensive data on total taxation revenue collected from property in Australia are not available. Also, reliance on specific property taxes such as stamp duty, varies substantially at the state level. For example, the Real Estate Institute of Australia (sub. 124, p. 11) estimated that, in 2002-03, property taxes as a share of total revenue available to each state and territory ranged from 1.5 per cent in the Northern Territory and 3.3 per cent in Tasmania, to 9.5 per cent in Victoria and 11.1 per cent in NSW.

2.2 How much have house prices risen?

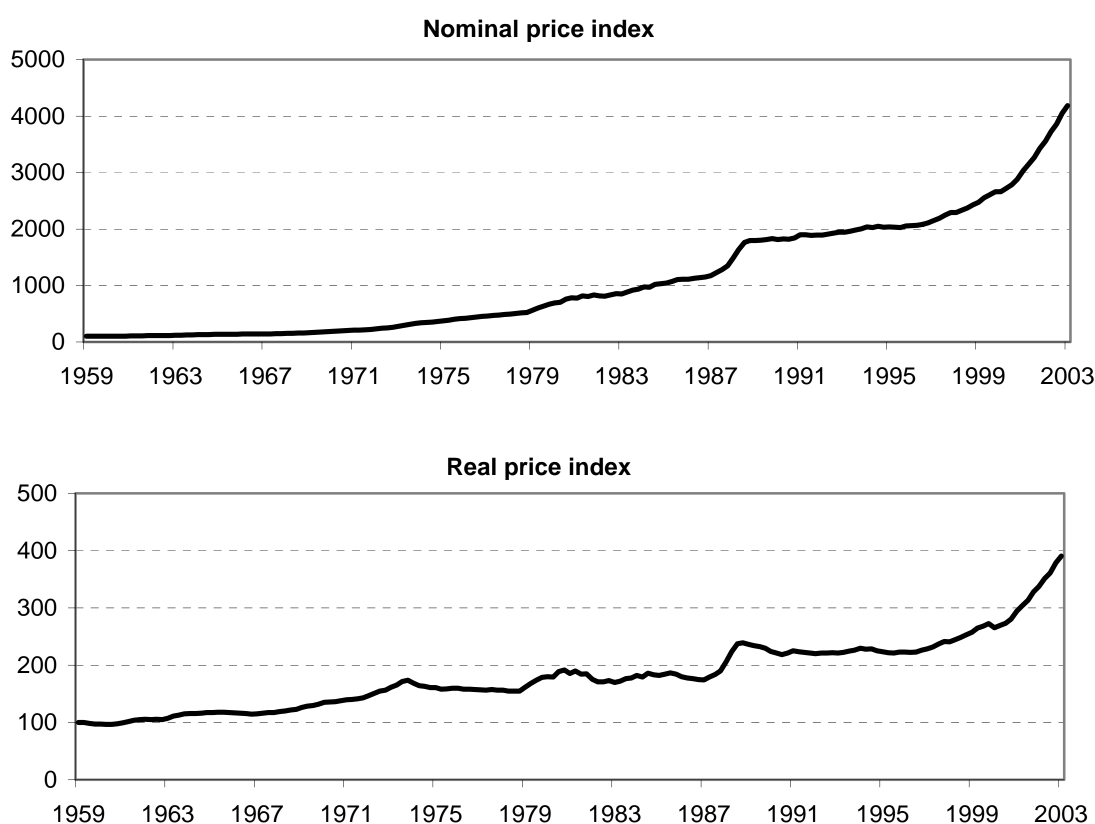
The impacts of recent sharp increases in house prices in many parts of Australia on aspiring first home buyers, have been the trigger for this inquiry. However, periods of stronger or weaker price growth — and even price falls — are an inherent feature

of the housing market in Australia and in many other countries. Hence, a threshold issue for this inquiry is whether the recent upturn in house prices is unusual in a historical context. (As noted in chapter 1, except where price data refer specifically to detached houses, the term 'house prices' is used generically to encompass all types of residential dwellings, including the land.)

Substantial price growth over the long term

Since 1970, real prices for (detached) houses in Australia have more than trebled, representing a trend increase of around 2.3 per cent a year (see figure 2.1 and table 2.1). By international standards, this is a high rate of price increase, above that in nine of the eleven European Union countries covered in a UK Treasury (2003) study of house price trends over a similar period.

Figure 2.1 **House price growth in Australia**



Note. These price series are for detached dwellings only, indexed with 1959 as the base period. They are derived by extrapolating the ABS House Price Index between 1987 and 2003 to the period 1978 to 1986 using REIA data on dwelling price growth, and to the period 1959 to 1979 using BIS Shrapnel price data. The real price series is deflated using the household consumption deflator in the national accounts.

Data source: Australian Government Treasury (unpublished).

However, there has been marked variation in the rates of price increase both between the capital cities (see table 2.1) and within them. For example, over the past decade, annual real rates of increase in individual Melbourne suburbs have ranged from minus 3 per cent to plus 16 per cent (see figure 2.2). A similar spread, from minus 2 per cent to plus 14 per cent, has been evident in Sydney. And, were data available to allow comparable estimates, similar variation between and within regional centres would also be expected.

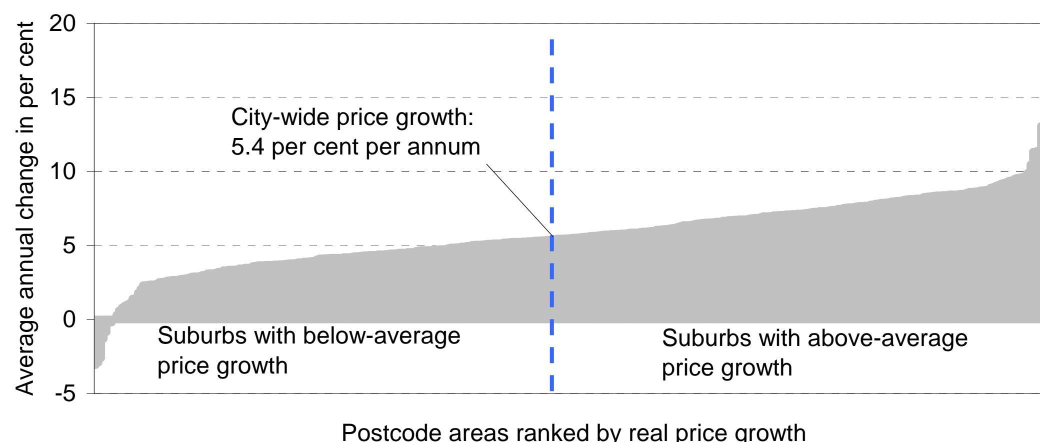
Table 2.1 **Trend growth and volatility of Australian house[a] prices**

	Period	*Real annual growth rate*[b]	*Volatility*[c]
		per cent	per cent
Sydney	1970 to 2003	2.7	9.2
Melbourne	1970 to 2003	2.1	10.7
Brisbane	1980 to 2003	3.2	8.5
Adelaide	1974 to 2003	1.2	8.1
Perth	1980 to 2003	2.8	6.4
Canberra	1980 to 2003	2.0	7.9
Hobart	1991 to 2003	1.5	6.4
Darwin	1987 to 2003	3.4	6.7
Australia	**1970 to 2003**	**2.3**	**6.3**

[a] Detached dwellings only. [b] Based on a regression of (log) real prices on a constant and a time trend, with prices deflated by the consumer price indexes for the respective capital cities. [c] Average annual percentage deviation of median detached dwelling prices from price trends.

Sources: Productivity Commission estimates using data from the Australian Government Treasury (unpublished), Valuer-General Departments (or equivalent), and REIA (unpublished).

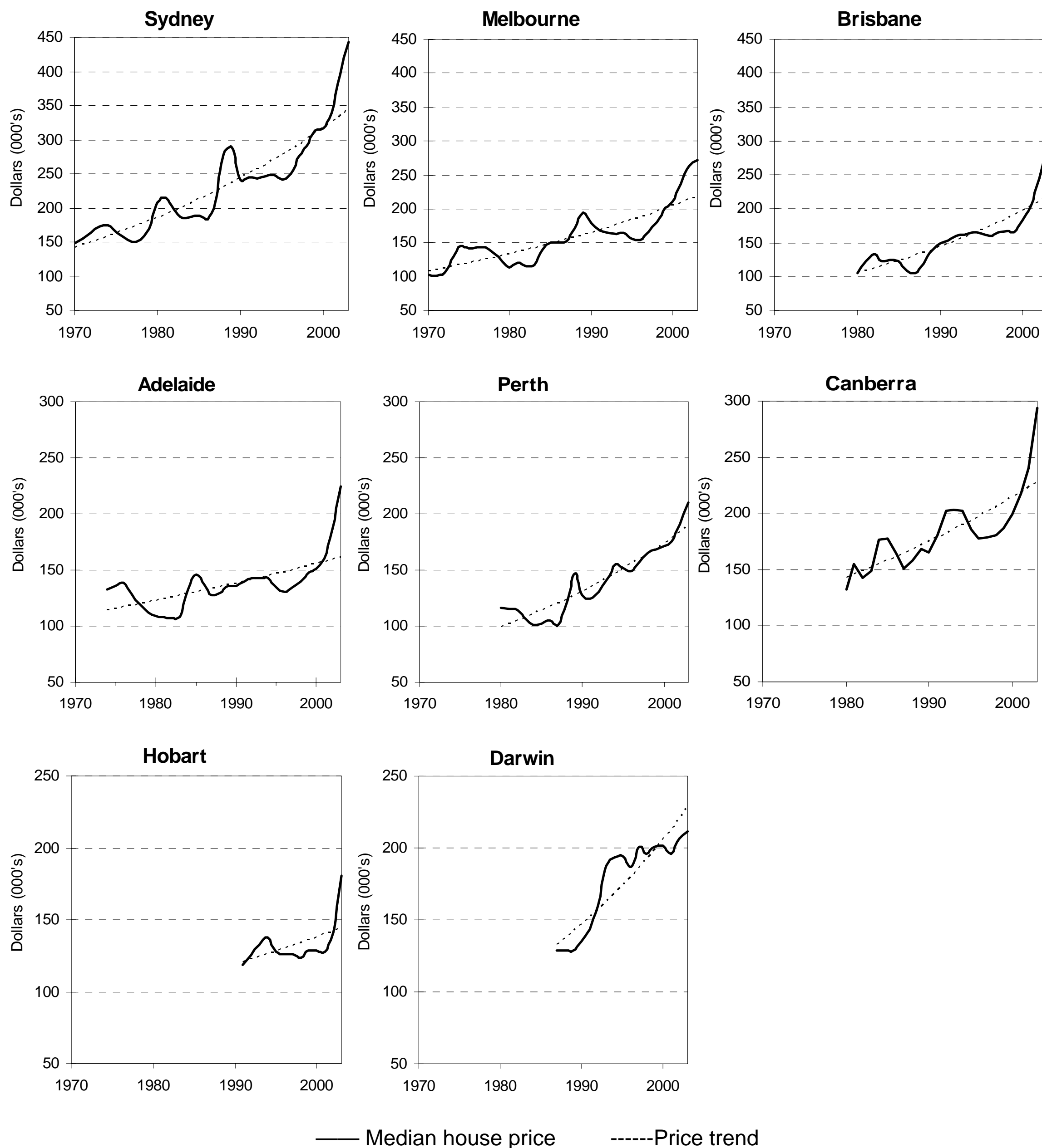
Figure 2.2 **Real price growth for detached dwellings in Melbourne suburbs from 1993-94 to 2002-2003**



Source: Productivity Commission estimates based on data from DSE (2003a).

Over the past few decades, there also have been several significant price upswings, as well as periods where real house prices have fallen substantially (see figure 2.1) Again, however, the degree of price volatility has varied between the major cities (see table 2.1 and figure 2.3).

Figure 2.3 **Median (detached) house prices in Australian capital cities since 1970**
(2003 dollars)



Note. Prices for 2003 are based on sales in the first three quarters of the year.

Source: Productivity Commission estimates based on data from the Valuer General Departments (or equivalent) for Sydney, Melbourne and Adelaide, and data from the REIA for Brisbane, Perth, Canberra, Darwin and Hobart.

As several inquiry participants observed, reductions in real prices have most often been due to a flattening of nominal price growth combined with the effects of inflation (see figure 2.1). But there have been instances where nominal prices have fallen appreciably — Sydney in the late 1980s being a case in point. Moreover, with inflation now being sustained at much lower levels than in the past, declines in nominal house prices might be expected to become more common.

Is the recent upswing unusual?

From the trough in early 1996, the Australia-wide average price for a (detached) house has more than doubled in nominal terms and risen by nearly 80 per cent in real terms. Over half of this price increase has occurred in the past three years.

Though well above long-term trends, the rate of price increase has been lower than in some previous cycles. For example, during the peak of the boom in the late 1980s, average house prices rose by 40 per cent in one year.

In an international context, the recent boom in Australia is also not unique. Since the mid-1990s, several other countries have recorded larger house price increases than Australia (see table 2.2).

Table 2.2 **International house price growth, 1995 to 2002**

Country	*Nominal increase*	*Real increase*
	per cent	per cent
Ireland	219	152
United Kingdom	125	89
Netherlands	121	83
Spain	95	58
Australia	**72**	**48**
Sweden	68	56
Belgium	57	39
United States	51	27
France	45	31
Italy	29	8
Canada	18	2
Germany	-5	-13
Japan	-20	-19

Sources: The Economist (2003), except the figure for Australia which is calculated from ABS (*House Price Indexes*, Cat. no. 6416.0).

However, compared with previous booms in Australia, the recent upswing in prices is different in key respects.

First and foremost, it has been more prolonged and has occurred at a time when inflation has been low. As a result, the cumulative real increase in house prices has been larger than in previous upswings — for example, roughly double that in the boom of the late 1980s (RBA sub. 199, p. 10).

Strong price growth has also been geographically more widespread than in some previous upswings:

- While price increases in the early part of the boom were mainly evident in the more expensive suburbs of Sydney and Melbourne, prices have subsequently risen across these cities and in the other capitals (see figure 2.3). More specifically, Commission analysis of house price changes within Sydney and Melbourne indicates that:
  - In the first two years of the boom, annual price growth was typically higher in suburbs close to the Central Business District (CBD).
  - Since then, price growth has often been faster in suburbs further from the city centre — especially between 1998 and 2000 in Sydney and in 2001-02 in Melbourne.
- There have also been significant price rises in many regional centres. For example:
  - The Newcastle City Council (sub. 176, p. 8) said that, in the past four years, average price increases in Newcastle have been higher than in the Sydney Statistical Division.
  - The NT Treasury (sub. 197, p. 1) noted that, since the late 1990s, prices have grown faster in Alice Springs than in Darwin.
  - The SA Government (sub. 98, p. 8) commented that while prices have risen most strongly in Adelaide, average prices outside the metropolitan area have still increased by 50 per cent over the past four years.
  - The WA Government (sub. 190, p. 7) pointed to solid price growth in regional centres, noting that prices in Broome have recently been increasing faster than in Perth.

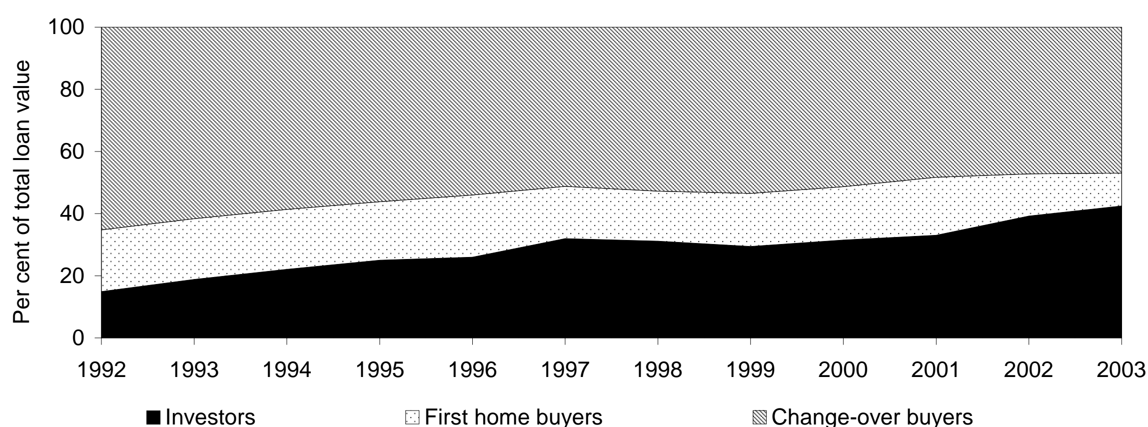
Further, unlike the booms in the early 1970s and late 1980s, the recent upswing has been limited to the residential property market. As the Reserve Bank of Australia (RBA) (sub. 199, p. 12) observed, prices for commercial properties across Australia have been increasing at an annual rate of just over 4 per cent since the mid-1990s, with current price levels in all of the capital cities still below the peaks of the late 1980s.

It also appears that the upgrading of owner-occupied housing through the purchase of higher quality and/or better located dwellings (so-called 'change-over' buying) has played a greater role than in previous booms. As discussed in chapters 3 and 4, such upgrading has been encouraged by cheaper and more available housing finance and strong income growth. According to the market analyst BIS Shrapnel (2004), demographic factors, such as the 'empty nest' phenomenon and increased migration to coastal centres outside the major cities, have also played a role. And some inquiry participants, for example Pollard (sub. DR253, p. 3), contended that more limited purchasing options for first home buyers (see below) make it more likely they will trade up subsequently into better housing.

The surge in investment in rental housing

A final feature of the recent upswing is that sharply rising investment by households in rental housing has played a very important role, especially in the last few years. Since the mid-1990s, loan commitments for investment properties have risen from a little over 20 per cent to more than 40 per cent of the value of total new housing loan commitments. More than half of this increase has occurred since 2000 (see figure 2.4). According to the RBA (sub. 199, p. 18), investors now account for one-third of banks' outstanding housing loans, up from 15 per cent in the early 1990s.

Figure 2.4 **Share of housing loan commitments by type of buyer**



Note. Excludes refinancing of established dwellings.

Data source: ABS (*Lending Finance*, Cat no. 5671.0; *Housing Finance for Owner Occupation*, Cat. no. 5609.0).

Notably, there has been a large increase in the *number* of households purchasing rental properties (as distinct from existing landlords expanding their rental portfolios):

- According to the Australian Tax Office, 13 per cent of taxpayers reported earning rental income in 2000-01, compared with 9 per cent in the early 1990s.
- Recent household survey data suggest that this share may have since increased to nearly 17 per cent (Uren 2004).

These proportions are much higher than in some other ‘comparable’ countries. In the United States and Canada, for example, around 6.5 per cent of households own a rental property, while in the United Kingdom, the share is just 2 per cent — though it has been rising of late (RBA sub. 199, p. 19).

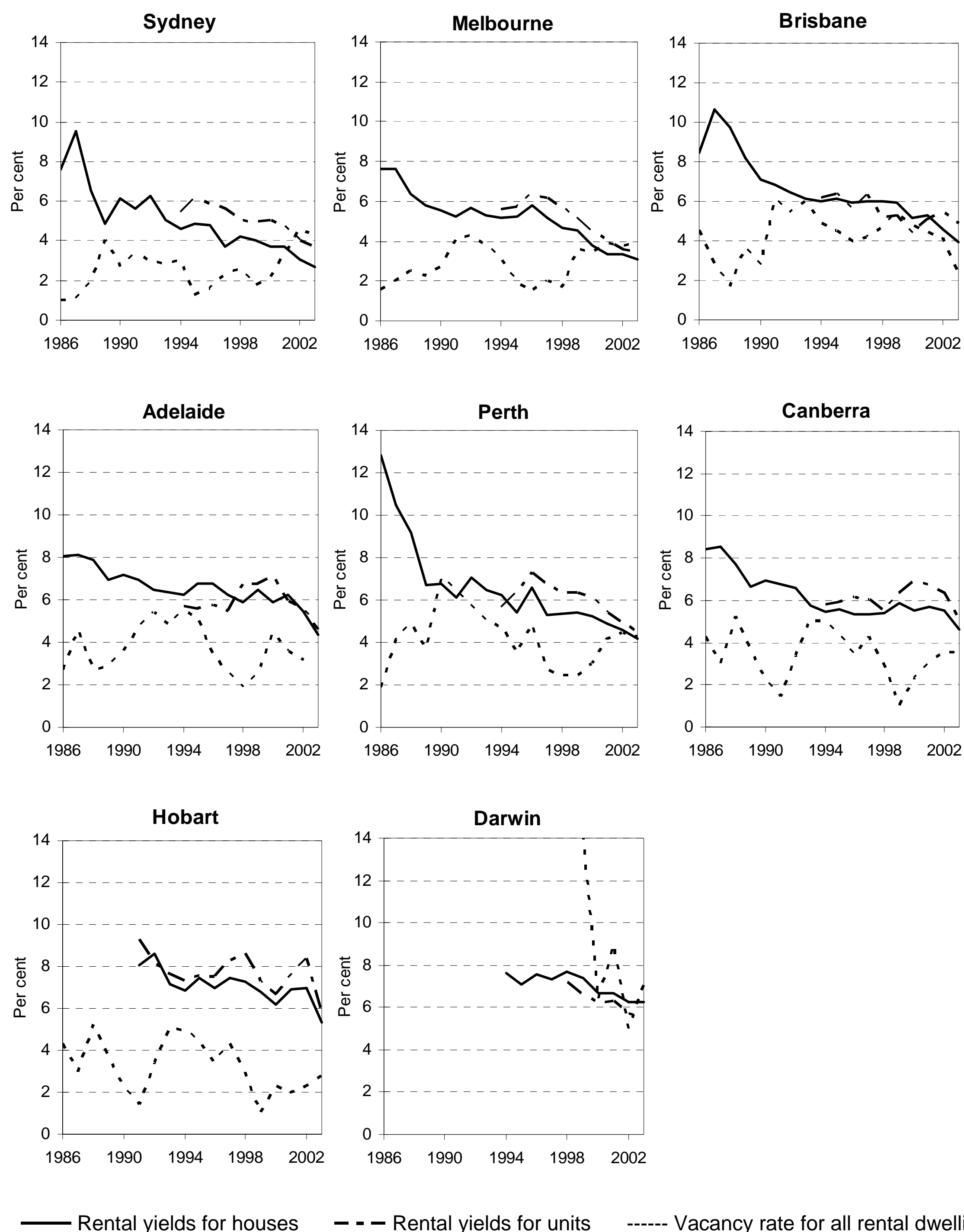
There has also been an increase in foreign investment in Australian residential property. According to the Foreign Investment Review Board (2004), which is responsible for scrutinising foreign investment, the value of approved proposals for overseas investment in residential real estate increased from $5.9 billion in 1995-96 to $9.3 billion in 2002-03. More than 80 per cent of approvals in 2002-03 were for the purchase of land or new housing developments. This is consistent with current policy, which aims to channel foreign investment into the supply of new housing. According to the NSW Government (sub. 187, p. 18), overseas investors have shown particular interest in the provision of moderately priced, high rise apartments in the Sydney CBD.

Of course, some approved proposals will not ultimately proceed. Moreover, in other cases, the spending will be spread over a number of years. Nonetheless, the figures just cited suggest that increased foreign investment has contributed to demand and price pressures during the recent upswing.

Very strong investment demand has been evident despite falling rental yields and, more recently, growing vacancy rates in some cities (see figure 2.5). Across Australia, gross rental yields for detached dwellings now average around 3 to 3.5 per cent, with the yield on apartments and units being only a little higher. By comparison, the RBA (sub. 199) reported that average yields in the United Kingdom and the United States are around 7.5 per cent. And in Canada, yields on residential property typically appear to range from 6 per cent to as much as 12 per cent (Royal LePage Real Estate Services 2003). Clearly, such comparisons must be treated with caution. Apart from sampling issues, whether the yield on residential property in a particular country is high or low must be considered in the context of returns on other classes of investment, and of any country-specific factors bearing upon yields on residential property (see further discussion in chapter 9).

Nonetheless, there is widespread agreement that returns in Australia are currently at the low end of the international spectrum.

Figure 2.5 **Rental yields and vacancy rates for Australian capital cities**



Note. Rental yield is equal to the ratio of the median annual rent to the median dwelling price. Rental yields for 2003 are averages for the first three quarters of the year.

Sources: Productivity Commission estimates based on unpublished data from the REIA and RBA.

The reasons underlying the surge in investment demand despite declining rental yields are considered in subsequent chapters, as part of the Commission's general assessment of the factors that have underpinned the recent boom in house prices.

Finally, the Commission notes that most of the decline in rental yields has resulted from rising house prices rather than falling dollar rents. In most of the capital cities, the ratio of median rents to average household disposable income has been reasonably stable over the past decade.

However, such market-wide statistics conceal considerable variation between individual segments within regional markets. For example, while there is recent evidence of falling dollar rents at the top end of the apartment market in some cities, several inquiry participants claimed that, at the bottom end of the market, a decline in the stock of affordable properties has seen rents rise sharply in recent years in a number of centres (see box 2.1). Housing affordability for low income households is discussed further below and in chapter 10.

Box 2.1 **Concerns about the affordability of rental housing**

While median rents as a proportion of household income have been quite stable in most parts of Australia in recent years, several inquiry participants raised concerns about a growing shortage of rental housing that is affordable for lower income households. They said that this is making it more difficult for some of these households to save a housing deposit, as well as causing stress for many of the larger group of low income households for whom home ownership is always likely to be beyond reach.

These participants attributed the perceived shortage of affordable rental housing partly to reductions in (real) levels of government spending on public and community (social) housing. For example, the Tasmanian Government argued that as a result of changes to funding arrangements under the Commonwealth–State Housing Agreement:

> The public rental-housing portfolio is currently unviable and reduction in funds to support it is having significant impact on Housing Tasmania's operations. In the medium to long-term, capacity to maintain levels of public sector housing stock, let alone increase levels to meet existing demand, will pose a significant challenge. (sub. DR320, p. 15)

And the Community Housing Federation of Victoria said:

> … although it was originally designed to accommodate working families, public housing has become increasingly targeted to the most disadvantaged. Just being on a low income no longer ensures access to [social] housing. Most current tenants are in receipt of Centrelink payments, and are described as having 'high' or 'complex' needs. (sub. 142, p. 2)

However, it also contended that the decline in the stock of public housing has not been matched by an increase in the supply of low cost private rental accommodation, leading to sharply increased rental costs at the cheaper end of the market in some cities and regions. Thus, the Housing Justice Roundtable commented:

(continued next page)

Box 2.1 **(Continued)**

> Unfortunately, increased demand for low cost rental housing has forced prices up, making it less low cost and new investment has not increased [the] supply of affordable, well-located housing. (sub. 181, p. 2)

Further, while acknowledging that indexation of Commonwealth Rent Assistance (CRA) payments has helped to offset the impacts of rising private rentals for those on social security benefits, some inquiry participants contended that CRA payments have failed to keep up with 'needs'. According to the Australian Association of Social Workers (sub. 158, p. 7) this has rendered '… the private rental market unaffordable for many of those on low incomes'.

Amongst the evidence cited to support these contentions was a suite of studies by Wulff and Yates (2000), Wulff, Yates and Burke (2001) and Yates, Wulff and Reynolds (2004) comparing the stock of low-rent dwellings with the number of low income households. All three of these studies reported the existence of a substantial shortfall in low-rent dwellings in the latter half of the 1990s, though the most recent study pointed to some reduction in the shortfall between 1996 and 2001.

Given the time available for the inquiry, and its focus on home ownership rather than housing affordability in the broad, the Commission did not subject these findings (and those in other similar studies) to detailed assessment. Moreover, data is not yet available to establish whether the large increase in investment in rental housing since 2001, has helped to alleviate previous shortages at the bottom end of the rental market. Nonetheless, it seems clear that many low income earners face serious affordability problems — whether paying off a home or renting their accommodation.

Sources: Submissions; Wulff and Yates (2000); Wulff, Yates and Burke (2001); and Yates, Wulff and Reynolds (2004).

2.3 What has happened to housing 'affordability'?

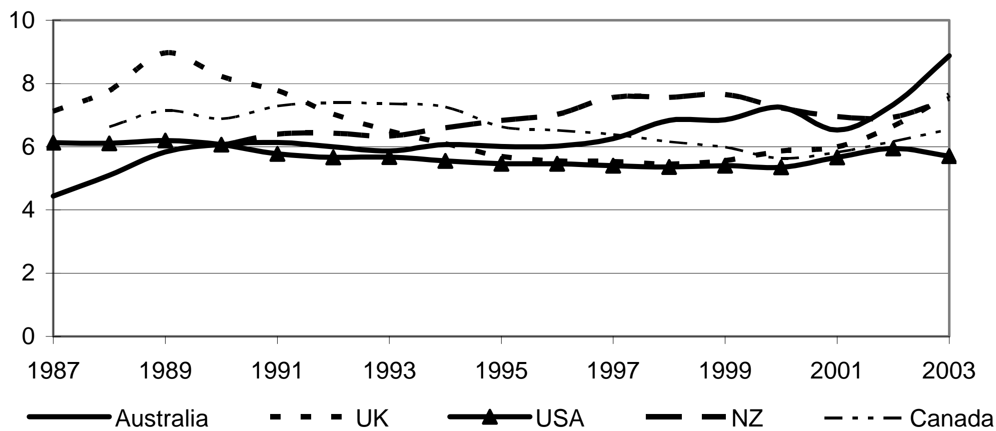
The recent sharp increase in house prices in most parts of Australia has seen affordability for first and other home buyers decline.

A commonly cited indicator of this decline is the increase in the ratio of the median house price to average per capita income. For Australia as a whole, this ratio has risen from 6 at the beginning of the recent upswing to around 9 (see figure 2.6) and now appears to be high by international standards (RBA sub. 199, p. 13).

However, the price-to-income ratio is only a partial indicator of affordability trends. In particular, it does not take account of the cost of housing finance. As discussed in chapter 3, reductions in interest rates which have enabled households to finance much larger housing loans from a given income, appear to have been one of the key drivers of increases in Australian house prices since the mid-1990s. Hence,

discussions of trends in affordability — especially over the short to medium term — typically rely on indexes that incorporate the effects of changes in borrowing costs.

Figure 2.6 **Ratio of median house prices to average per capita income in Australia and overseas**



Note. Data for Canada based on average rather than median house prices.

Sources: Productivity Commission estimates based on unpublished data from Halifax, US Commerce Department, OECD, Canadian Real Estate Association, Real Estate Institute of New Zealand and HIA.

The published indexes of housing 'affordability' in Australia (see box 2.2) fall into two groups:

- those that relate mortgage repayments to household income; and
- those that measure the extent of the 'deposit gap' that must be funded by home buyers. These are sometimes referred to as 'accessibility' indexes.

Figures 2.7 and 2.8 provide examples of both of these index types.

These indexes are sensitive to underlying house price and income assumptions, and to whether their focus is on the size of the 'deposit gap' or the capacity of households to service a 'typical' home loan. Nevertheless, all indicate that, following an improvement in the early years of the recent upswing, affordability has declined appreciably in the last couple of years. Indeed, the two indexes produced by the Commonwealth Bank of Australia–Housing Industry Association (CBA–HIA) (see box 2.2), suggest that, in parts of Australia, affordability for first and other home buyers is now worse than in the late 1980s when interest rates were very high. And though the AMP–REIA and BIS Shrapnel indexes suggest that affordability is still generally better than at that time, the gap is narrowing. All of the indexes show that, among the capital cities, affordability problems are most acute in Sydney.

Box 2.2 **Housing affordability indexes**

The most widely reported indexes of housing affordability in Australia are:

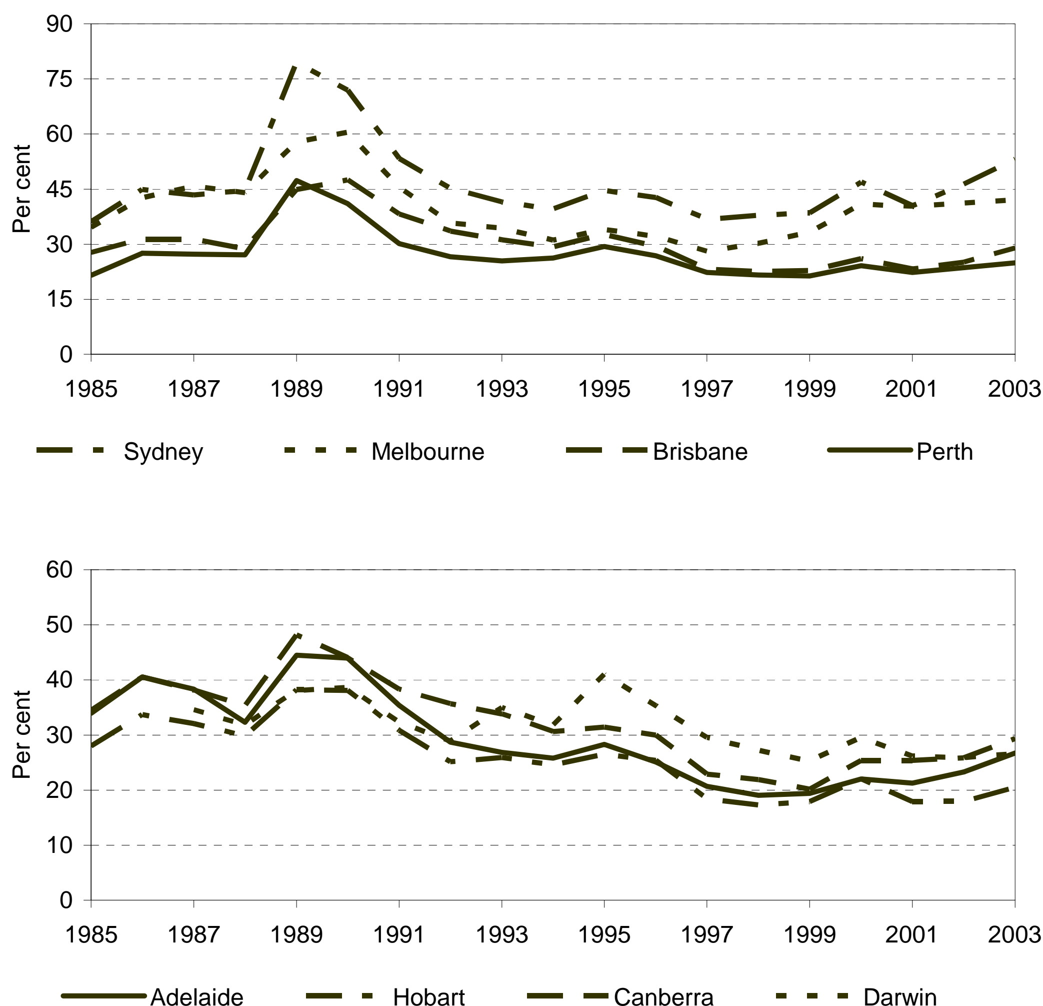
- The *AMP Banking–Real Estate Institute of Australia Housing Affordability Index* — the ratio of median household income to average loan repayments, with the latter based on the average size of new loans in each quarter.
- The *BIS Shrapnel Home Loan Affordability Index* — the ratio of mortgage repayments on a 'typical' housing loan to average full-time male earnings. The former assumes a 25 year loan for 75 per cent of the median house price.
- The *Commonwealth Bank of Australia–Housing Industry Association* (CBA–HIA) Housing Affordability Index — the ratio of average household disposable income to the 'qualifying' income required for a 'typical' first home loan. Qualifying income is calculated on the assumption that repayments on a 25 year loan, for 80 per cent of the price of a 'typical' property purchased by a first home buyer, are equal to 30 per cent of household income. Up until 1988, the price of a typical dwelling purchased by first home buyers was directly estimated from loans approval data. Since that time, it has been based on the 1988 price, indexed by subsequent movements in the market-wide median price.
- The *CBA–HIA Deposit Gap Index* — the difference between the price of a 'typical' dwelling and the maximum loan that could be repaid from average household income, expressed as a proportion of that income. The dwelling prices in this index are the same as in the other CBA–HIA index.

All of these indexes have limitations. For example, all are based on median prices in each period and thus do not account for changes in the composition of sales (dwelling type and location) between periods. One consequence is that collective decisions by households to spend more on higher quality or better located houses will be manifest as a decline in measured affordability — a particular limitation in the context of the recent upswing, where much of the demand pressure has come from households seeking to upgrade their housing. Also, the indexes do not account for changes in lending practices which have reduced deposit constraints (chapter 3).

As discussed in box 2.2, only the CBA–HIA indexes relate specifically to prices paid by first home buyers. And even these indexes are based on prices paid in the late 1980s, adjusted for subsequent changes to market-wide median prices. However, indexes calculated by the Commission based on the average size of mortgages taken out by first home buyers — for which data have been continuously available since the early 1990s — showed similar trends to these CBA–HIA indexes. Figure 2.9 provides an illustration of this.

The Commission notes that because of the lower dwelling prices used in its indexes, absolute levels of affordability appear better than in the corresponding CBA–HIA indexes.

Figure 2.7 **The BIS Shrapnel home loan affordability index**



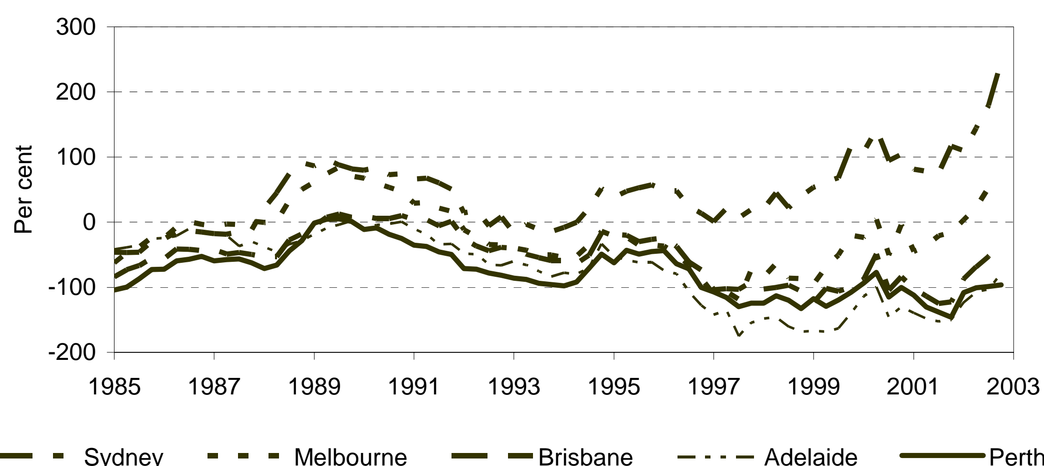
Note. At June of each year. Mortgage repayments on a 25 year loan equal to 75 per cent of the median house price at the standard bank variable housing interest rate, expressed as a percentage of average full-time male earnings.

Source: BIS Shrapnel (2003).

But this is partly because the gap between median market prices — used to adjust the CBA–HIA indexes since the late 1980s — and average prices actually paid by first home buyers has widened during the recent boom. This movement of first home buyers 'down-market' is in itself symptomatic of declining affordability for those seeking to achieve home ownership. It highlights the need, when looking at these sorts of indexes, to focus on trends as well as levels.

More broadly, indexes that simply link average house prices to interest rates and some measure of average income cannot provide a complete picture of what is happening to affordability:

Figure 2.8 **CBA–HIA deposit gap index**

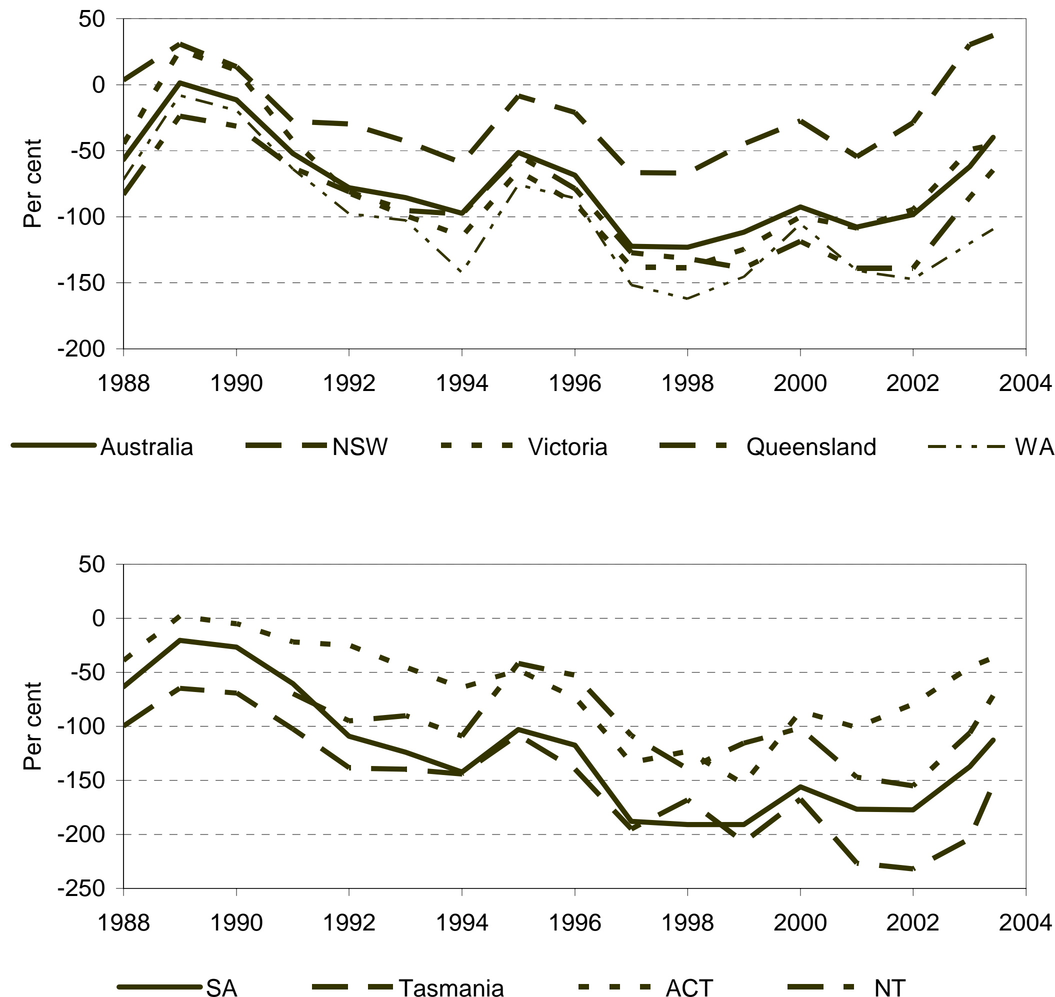


Note. The difference between the price of a 'typical' dwelling (see box 2.2) and the maximum loan that could be repaid from average household income, expressed as a proportion of that income. A decrease in the index represents an improvement in affordability. Data are from the March quarter 1985 to the December quarter 2002.

Source: HIA (unpublished).

- Importantly, they do not account for improvements in the quality of housing over time. As a number of submissions pointed out, the average size of new houses has been increasing, and the quality of fittings improving. The standard of infrastructure — such as roads and drainage — and the range of community facilities available to residents in new developments, is now much greater than in the past. And upgrading of the existing housing stock has been ongoing. Indeed, as noted above, around 40 per cent of total residential construction expenditure is for alterations, additions and maintenance. But against these trends, block sizes for new homes have generally been declining. Also, the trend towards medium and high density dwellings would similarly be reducing the land to dwelling ratio, albeit slowly. The net impact of these competing influences is discussed further below in relation to changes in the affordability of housing in Australia over the long term.
- Ultimately, affordability depends on the ongoing costs of home ownership as well as the purchase price. Of particular relevance in this regard is the common contention that market-wide price rises have forced first home buyers to purchase in locations further away from their places of employment, leading to increased commuting costs. This contention, which is supported by some Commission analysis of price changes by suburb (see below), also serves to illustrate the element of circularity in affordability indexes — the prices in those indexes reflect what people can afford to pay.

Figure 2.9 **First home buyer deposit gap as a proportion of average household disposable income**



Note. Calculated on a similar basis to the CBA–HIA index in figure 2.8, but using prices derived from the average size of mortgages taken out by first home buyers, for which data have been continuously available since 1991. For the period prior to 1991, prices were estimated from market-wide prices.

Source: Productivity Commission estimates based on ABS (*Housing Finance for Owner Occupation* Cat. no. 5609.0; *Australian System of National Accounts*, Cat. no. 5204.0).

- Because the indexes are based on average income measures, they will not necessarily indicate what is happening to affordability for the many households with below-average incomes. Though the majority of first home buyers have above-average incomes, they are nonetheless a diverse group (see box 2.3 and appendix B).

Box 2.3 **Who are the 'first home buyers'?**

- The majority of first home buyers are aged in their twenties and thirties.
- Most are couples, though the proportion of lone person households buying a first home has increased by 50 per cent since 1990.

Selected household characteristics

	1990	*2000-01*
	per cent	per cent
Lone person	12	18
Sole parent	5	4
Couple only	33	32
Couple with children	36	33
Proportion aged		
15 to 24	15	10
25 to 34	54	61
35 to 44	20	19
45 to 54	8	8
55 and over	3	3

Data sources: ABS (*Housing Occupancy and Costs, Australia*, Cat. no. 4130.0); unpublished data from ABS 2000-01 Survey of Income an Housing Costs.

- The majority of households buying a first home have above-average incomes, with 55 per cent reporting gross weekly incomes in the top two income quintiles in 2001. Though this share was little different from a decade earlier, a growing proportion of households buying a first home have two or more income earners.
- Lower income first home buyers — those in the second income quintile — tend to be slightly more evenly distributed over the age spectrum than first home buyers as a whole. Not surprisingly, there are also more lone person/single income households in this group. Compared to renters in the same income quintile, these lower income home buyers are younger on average and less dependent on social welfare. Also, while 30 per cent of second income quintile renters are sole parents, this household type accounts for only 5 per cent of lower income first home buyers.
- More first home buyers are purchasing townhouses and apartments (20 per cent in 2000-01 compared with 12 per cent a decade earlier). They are also purchasing fewer new dwellings (20 per cent in 2000-01 compared with 26 per cent in 1994).
- First home buyers rely heavily on debt finance — in the three years to 1999, the average deposit paid was 10 per cent of the purchase price.

Sources: ABS (*Housing Occupancy and Costs, Australia*, Cat. no. 4130.0); unpublished data from ABS 2000-01 Survey of Income and Housing Costs.

- Similarly, the use of Australia-wide income measures means that the indexes do not pick up the impact of regional differences in incomes on housing affordability. For example, to the extent that average incomes are higher in Sydney than in some of the smaller capital cities, the indexes in figures 2.7 to 2.9 will overstate the magnitude of the difference in affordability between Sydney and these other centres.

In the light of these shortcomings, the Commission looked at several other indicators of what has recently been happening to affordability for first home buyers, as well as examining how affordability has been changing over the much longer term. As a number of inquiry participants pointed out, in many respects, it is the underlying 'structural' trend in affordability rather than shorter-term cyclical movements that should be the focus of policy attention.

Home ownership levels

By international standards, the rate of home ownership in Australia is quite high (see table 2.3). But even abstracting from the methodological difficulties in estimating ownership rates (Mudd et al. 2001), such international comparisons shed little light on the affordability of housing in individual countries. In particular, ownership rates will vary across countries for a range of reasons unrelated to affordability — for example, the typical length of time that children stay at home and the availability of public and community housing. Spain and Ireland, which have amongst the highest recorded levels of home ownership in the world, both experienced faster house price growth than Australia between 1995 and 2002 (see table 2.2).

Of more relevance, therefore, is what has been happening to the home ownership level in Australia over time and, more particularly, whether it has declined during the recent upswing in house prices. Again, methodological issues mean that caution is required in drawing conclusions from small changes in estimated ownership rates. Nonetheless, the weight of evidence suggests that, in the period prior to the commencement of the recent boom, there was a material decline in home ownership in Australia. For example, using unpublished census data, Mudd et al. (2001) estimated that the ownership rate declined by two percentage points between 1981 and 1996, with Yates (2002) calculating a similar decline for the period 1986 to 1996.

Significantly, during the 1980s and the first half of the 1990s, ownership rates appear to have dropped more sharply in younger age groups. Commission estimates based on the census data indicate, for instance, that between 1981 and 1996, the rate for 15 to 24 year olds fell from 27 per cent to 22 per cent, for 25 to 34 year olds

from 63 per cent to 52 per cent and for 35 to 44 year olds from 78 to 70 per cent. These declines are broadly comparable in magnitude to those recently calculated by Yates (pers. comm., 2 February, 2004).[1]

Table 2.3 **Home ownership rates in selected countries**

Country	*Year*	*Ownership rate*[a]
		per cent
Spain	1998	83
Ireland	2000	78
Greece	1999	74
Belgium	2000	74
New Zealand	1996	71
Australia	**2001**	**70**
Italy	1998	70
United Kingdom	1999	69
United States	1999	67
Canada	1999	64
France	1999	55
Denmark	2000	53
Netherlands	2000	51
Germany	1998	43

[a] Proportion of households who own or are purchasing the house they live in.

Sources: ABS (*Australian Social Trends 2001*, Cat. no. 4102.0); Barker 2003, Annex A; Bernardi and Poggio (2002).

However, for the subsequent period 1996 to 2001 — the first five years of the recent upswing — the Commission's estimates suggest that:

- the overall home ownership rate in Australia increased marginally;
- declines in ownership rates in the 25 to 34 and 35 to 44 age cohorts were much smaller than in the preceding five year period; and
- the rate for the 15 to 24 age cohort actually increased by more than 2 percentage points.

Estimates provided to the Commission by Yates (pers. comm., 2 February 2004) show similar outcomes, though they suggest that ownership rates in the 25 to 44 age group actually rose slightly over this five-year period.

As noted above, all of these estimates are sensitive to the detailed methodologies employed. Moreover, the overall increase in the ownership rate between 1996 and

[1] A study by Harding et al. (2003), using Household Expenditure Survey data, and covering the period from 1989 to 1999, similarly estimated that the ownership rate in the 25 to 39 age group fell from 64 to 54 per cent.

2001 could simply be due to the ageing of Australia's population. That is, with home ownership being higher among older Australians, ageing of the population will, other things equal, lead to higher overall ownership levels. The Commission estimates, for example, that if the age composition of the population had remained unchanged since 1971, the measured ownership rate would currently be about 1 percentage point lower.

Nonetheless, the apparent slowing in the decline in home ownership among younger Australians between 1996 and 2001 is notable given some broader influences on tenure patterns pushing in the opposite direction. For example, as the HIA (sub. 177, p. 3) noted, younger Australians are waiting longer to buy their first homes, as they spend more time in education and defer entry to the workforce. They are also having children later, with some deferring home purchases while repaying Higher Education Contribution Scheme debts. Growth in the number of overseas students and other non-permanent immigrants (chapter 4), and greater casualisation in the labour market, are also likely to have shifted the tenure balance towards rental housing.

This in turn suggests that between 1996 and 2001, income growth, cheaper housing finance and various innovations in the home lending sector, such as low deposit and non-conforming loans (chapters 3 and 4), provided an offsetting boost to home ownership.

The recent sharp increases in house prices, and continuing high levels of investment in rental housing (partly in response to the sorts of demographic, economic and social developments outlined above), indicate that there may well have been more marked declines in ownership levels among younger Australians since 2001. However, (census-based) ownership data are not yet available for this period. Hence, it is still too early to say how movements in affordability over the duration of the recent upswing in prices have impacted on home ownership in Australia.

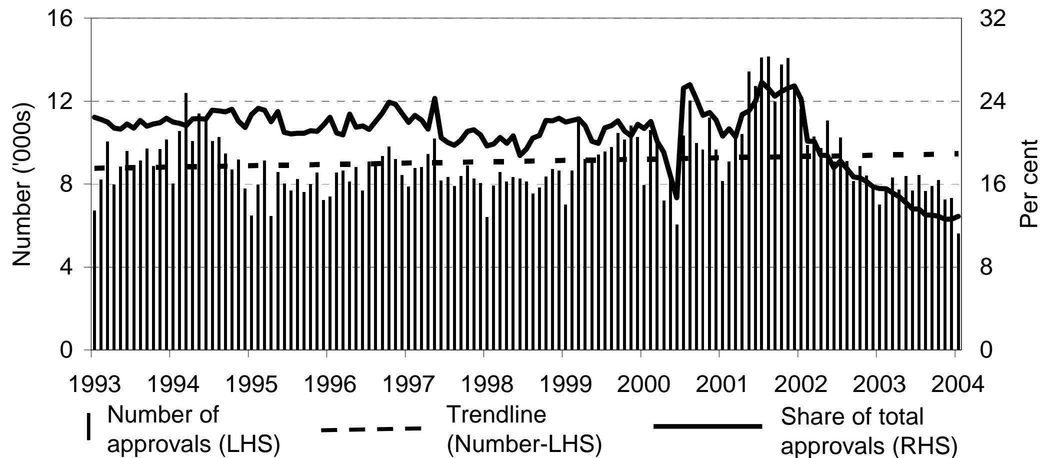
Numbers of first home buyers

Much has been made of the decline in the share of new housing loan approvals accounted for by first home buyers.

But, at least until the last couple of years, this was due to the strong growth in the number of loans taken out by 'change-over' buyers and investors in rental properties, rather than to a reduction in the number of approvals for first home buyers. Since the mid-1990s, the 'statistical' trend in the number of first home buyer approvals has in fact been marginally upward (see figure 2.10). Moreover, at least some of the recent fall in numbers will have been due to the preceding 'pull

forward' demand effect from the introduction of the Commonwealth Additional Grant component of the First Home Owner Scheme (chapter 4).

Figure 2.10 **Trends in loan approvals for first home buyers**



Note. Only includes loan approvals for owner-occupied housing.

Data source: ABS (*Housing Finance for Owner Occupation*, Cat. no. 5609.0).

That said, a continuation of the lower levels of first home buyer activity evident in the last couple of years would lend support to the view that entry to the housing market has recently become more difficult.

Location choices

A number of participants claimed that, as prices have risen, not only has the number of dwellings that first home buyers can afford fallen, but so too has the number of affordable locations within individual cities, towns and regions. For example, the NSW Government (sub. 187, p. 44) said that a household earning around $40 000 a year could afford to purchase less than 10 per cent of properties in the Sydney region. (For the purposes of these calculations, a property was deemed to be unaffordable if it entailed mortgage repayments in excess of 30 per cent of household income — the usual marker of 'housing stress' for lower income households.) The NSW Government further claimed that for households earning the median household income for NSW outside Sydney, less than 20 per cent of dwellings in coastal regional areas could affordably be purchased. This compared with a figure of more than 40 per cent for non-coastal regional areas.

The purchasing options for first home buyers in Sydney have of course been limited for a number of years now. The data provided by the NSW Government indicate

that, since 1994, the maximum share of the stock that could have been 'affordably' purchased by first home buyers has been about 25 per cent, with the share during much of 1995 and 1996 being only slightly higher than at present. These data further suggest that, outside Sydney, the share of the stock affordable for first home buyers has actually been higher in the past two years than for much of the past decade (sub. 187, p. 42).

Nonetheless, research undertaken by the Commission on rates of house price increase in suburbs adjacent to the major transport corridors of Sydney and Melbourne, supports the view that locational choices for first home buyers have diminished somewhat in these two cities over the past decade or so:

- In 1992, a representative Victorian home buyer able to afford to pay the Melbourne-wide median price, would have been able to purchase the median-priced house in a suburb adjacent to the South Eastern freeway some 22 kilometres from the CBD. In 2002, taking account of the increase in the representative buyer's income — assumed to be equal to the average for all households — and the reduction in interest rates, the 'affordable (median-priced) home' would have been located in a suburb 24 kilometres from the CBD.
- Adjacent to the Nepean Highway in Melbourne, the equivalent suburb was 28 kilometres from the CBD in 2002 compared to 21 kilometres in 1992.
- Adjacent to the Campbelltown line in Sydney, the corresponding suburb distances were 24 kilometres in 2002 and 21 kilometres in 1995.

Whether similar outcomes would be evident for the other capital cities is unclear. For example, First Home Owner Scheme data show that, in some of the smaller capitals, first home buyers are purchasing in a wider range of suburbs. The lesser gap in some of these smaller cities between median prices paid by first home buyers and market-wide medians (appendix B), may similarly indicate wider locational choices than in Melbourne and Sydney.

Low income households

While the *trends* emerging from affordability indexes based on average incomes are relevant to all households, the *values* of those indexes will overstate the scope for low income households to achieve home ownership. For example, unpublished data from the Survey of Income and Housing Costs, indicate that, in 2000-01 prior to the most recent surge in prices, first home buyers in the second income quintile were spending an average of 30 per cent of disposable household income on housing. As noted, for low income earners, a level of more than 30 per cent is often regarded as indicative of 'housing stress'.

The difficulty that many low income households face in entering the market at this time is not, of course, a problem unique to the recent housing boom.

However, several social welfare organisations and unions argued that the problem has become more acute in recent years. For example, according to Yates (trans., p. 116), since the mid-1980s, home ownership rates in the lower income quintiles have fallen by more than in the higher income quintiles.

Inquiry participants focusing on the situation of low income earners contended that a worsening market-entry problem cannot be attributed solely to recent sharp increases in house prices. Other factors put forward as contributing to the difficulties of low income home buyers included greater casualisation of employment, as well as the previously noted concerns about a perceived decline in the stock of affordable rental housing and an increase in its cost (see box 2.1). According to these participants, declines in the stock of affordable rental housing have made it more difficult for low income households to save a housing deposit. The ACTU (sub. DR291) also contended that cut-backs in the public housing stock have reduced the constraining effect on house prices at the cheaper end of the market.

On the other hand, like other first home buyers, the scope for low income households to achieve home ownership has been improved by income growth (albeit slower than the average for all households), lower interest rates and innovations in the home lending market such as 'low documentation' and 'non-conforming' loans (chapter 3).

More broadly, the affordability issues confronting low income households are not limited just to those seeking to purchase a home. Access to affordable rental housing is a basic requirement for the wellbeing of the large number of low income households for whom home ownership may always be beyond reach. Thus, as discussed in chapter 10, the Commission sees merit in a broader and more holistic assessment of housing affordability than was envisaged or possible in this inquiry focussing on the costs of home ownership.

Long-term trends

As emphasised throughout this chapter, the affordability of home ownership, like house prices, has a strong cyclical element.

However, a number of respondents to the Discussion Draft suggested that the Commission had overplayed this cyclical element and underplayed what they saw as a longer-term structural decline in the affordability of home ownership. Some

characterised the Australian experience over the longer term as a 'ratchetting-up' of house prices, leading to a trend decline in affordability.

Taken at face value, the price data reported at the beginning of this chapter lend support to this view. The trend increase in real average house prices across Australia since 1970 has been 2.3 per cent. This compares with an average increase of about 1 per cent a year in real household disposable income over the same period (chapter 4). And, while interest rate movements can have a pervasive impact on affordability over the short to medium term, they may be less of an influence over the long term. Indeed, interest rates in Australia are currently at similar levels to those obtaining at the end of the 1960s.

Nonetheless, some caution is required in concluding that there has been a *substantial* decline in the affordability of home ownership over the last thirty or forty years:

- Such calculations are sensitive to the time period chosen. Thus, were there to be a prolonged period of price stagnation, or simply lower house price increases in coming years, the calculated difference between the long-term growth in prices and incomes would most likely diminish.
- There is variation in outcomes across regional markets. For example, while the trend increases in house prices in Sydney and Melbourne have been well above the average growth in household disposable income, prices in Adelaide have risen at much the same rate as income.
- Changes in the quality of housing become a much more significant consideration over the longer term than during a particular price cycle.

In this latter regard, it is obvious that the housing stock today is very different from that of the 1950s and 1960s. Houses are much larger and many features that were considered luxuries, or not even available at that time — for example, indoor toilets, four bedrooms, family (or 'rumpus' rooms) and en-suite bathrooms — are now regarded as essential by many home buyers.

As noted earlier, reductions in the average amount of land per dwelling would notionally have offset the additional costs of larger and better quality houses. Pollard (sub. DR253, p. 4) also contended that new urban land at the fringes tends to be intrinsically less attractive and thereby less valuable than land close to the CBD, concluding that 'the average value of land per dwelling in a non-monetary sense is clearly falling'.

But offsetting this are the considerable enhancements in housing-related infrastructure such as roads, drainage and sewerage, as well as in community

facilities and open space. For example, a member of the Planning Institute of Australia commented:

> Finished lots now come with not only fully constructed drainage and road infrastructure, but with highly embellished parklands, local maternal and child health centres and other community facilities, shopping centres (which are often developed ahead of threshold viable demand levels), sporting facilities and so on … In the past, affordability was assisted by the fact that initial buyers gained a very rudimentary product (often without made streets) and the infrastructures were brought on at a later time and paid for through recurrent charging mechanisms (like rates). (sub. 163, p. 7)

In any event, some long-term decline in 'quality constant' affordability would hardly be surprising. As discussed in chapter 4, housing is widely regarded as being 'income elastic'. This means that people will seek to spend more of their incomes on housing as those incomes grow. With some factors required to produce housing in scarce supply — particularly inner city land — an almost inevitable outcome will be higher prices for a given level of housing quality. Population growth and the trend towards smaller numbers of residents per household (chapter 4) will have similar price impacts.

2.4 Concluding remarks

The recent sharp increase in house prices in most parts of Australia has seen affordability for first and other home buyers decline. Indeed, the duration, geographical spread and cumulative extent of the price increases sets the recent boom apart from previous booms in the past 30 years.

However, as emphasised, house prices and the affordability of home ownership fluctuate widely around long-term trends. In the short term at least, prices can fall as well as rise. Similarly, affordability improves as well as declines — not only when prices fall, but also when interest rates go down or household incomes go up.

This of course is of little comfort to those households that are currently finding it very difficult to realise the goal of home ownership.

But the preceding observations are highly relevant to considerations of whether additional measures are needed to assist first home buyers cope with the impacts of the recent boom (chapter 10). While further price increases and interest rate rises may contribute to some additional deterioration in affordability in the short term, future 'softening' of house prices (chapter 9), in combination with continuing growth in incomes, is likely to see affordability for many aspiring first home buyers improve over time.

That in turn suggests that in seeking to improve the affordability of home ownership, it will be equally if not more important to focus on policy measures that take pressure off house prices over the long term, and that therefore provide enduring affordability benefits across housing cycles. The discussion in the next suite of chapters on factors underlying recent house price trends, points to a number of areas where policy initiatives would potentially yield such benefits.

3 The role of cheaper and more accessible finance

Findings

- Cheaper and more accessible finance has been an important driver of increased housing demand and rising house prices over the past eight years.
- Since interest rates peaked in 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 and thereby increased the incentive to borrow.
- However, there is no mechanistic relationship between the cost and availability of finance, levels of housing-related borrowing and house prices. A range of other demand-side factors have also increased the capacity and/or incentive for households to borrow for housing.
- The recent housing boom has highlighted the importance of appropriate regulation of lending practices and property investment advice. Initiatives to address shortcomings in regulatory requirements are being progressed in several forums.

In the recent housing boom, substantial price increases have been evident in most cities and regions. This suggests that factors common across Australia have been at work. With most house purchases at least partly financed by debt, cheaper and more readily available housing finance is widely viewed as having been an important contributor to the growth in demand and thereby to house price increases.

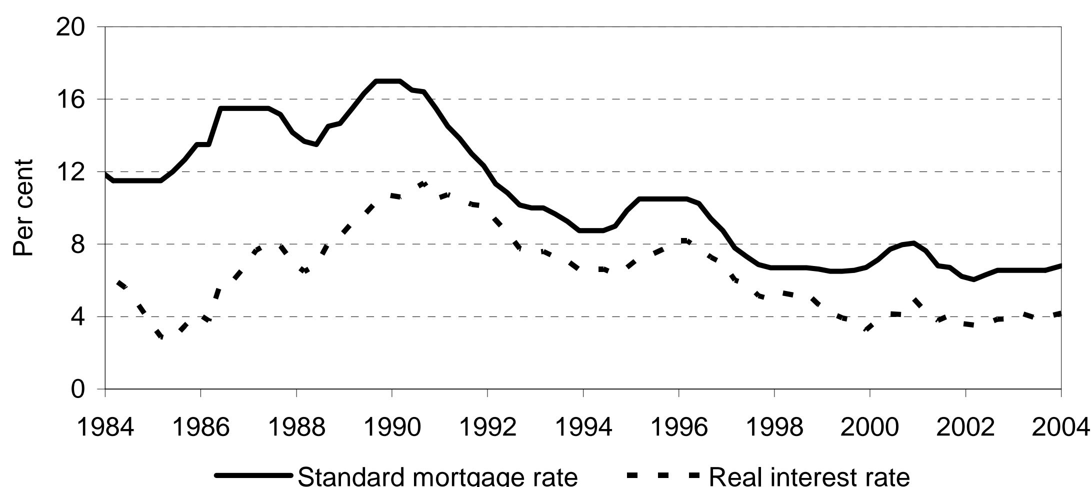
The Commission's analysis supports this assessment. Lower nominal interest rates have increased the amount households can borrow for housing from a given income. Innovations in home lending have simultaneously made it easier for many households to access finance for housing. And lower real interest rates have made both owner-occupied and rental housing more attractive as an investment and thereby increased the incentive for households to borrow. Collectively, these financial market developments have increased demand for housing by both owner occupiers and investors, and contributed to the recent large rise in borrowing for housing.

However, there is no mechanistic relationship between the cost and availability of finance, levels of housing-related borrowing and house prices. Hence, although financial market developments have clearly been influential, putting precise orders of magnitude on their contribution to price increases during the recent boom is not possible.

3.1 How much cheaper is housing finance?

Since their peak in 1990, nominal and real mortgage interest rates have more than halved (see figure 3.1 and table 3.1).

Figure 3.1 **Trends in variable mortgage interest rates**



Note. The real interest rate is equal to the standard variable mortgage rate deflated by the weighted median inflation rate (with the effect of the GST removed). Figure based on quarterly data.

Data source: RBA (2004a, 2004b).

Table 3.1 **Five-year average variable mortgage interest rates**

	Nominal interest rate (per cent)	*Real interest rate (per cent)*	*Maximum loan/annual income ratio* [a]
Sep 1983 to Jun 1988	13.4	5.6	2.2
Sep 1988 to Jun 1993	13.8	9.5	2.1
Sep 1993 to Jun 1998	8.9	6.7	3.0
Sep 1998 to Dec 2003	6.8	4.0	3.6

[a] Assumes that repayments for a 25 year loan do not exceed 30 per cent of annual disposable income, and that both interest and principal are repaid.

Source: Productivity Commission estimates based on RBA (2004a, 2004b).

Some of the decline in nominal rates has been due to lower inflation. Over the past decade, the annual inflation rate in Australia has averaged less than 3 per cent, compared to 6 per cent in the previous ten-year period.

However, until the late 1990s, real mortgage interest rates also fell considerably and have been broadly stable since. According to the Reserve Bank of Australia (RBA 2003e), lower margins resulting from the entry to the housing finance market of new lenders (see below) accounted for two percentage points of the reduction in real interest rates during the 1990s.

Moreover, the reductions in mortgage interest rates shown in figure 3.1 and table 3.1 understate the true fall:

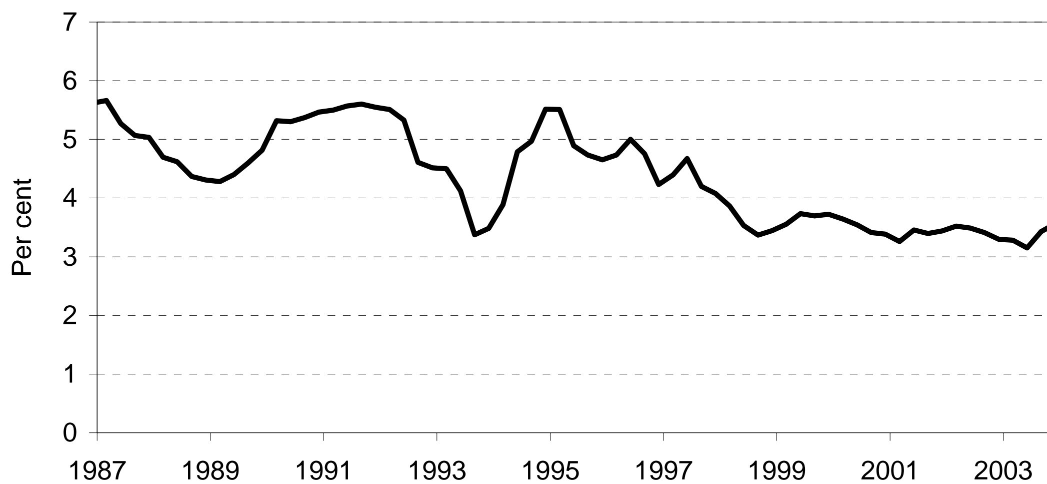
- During the 1980s, regulatory caps on bank lending rates meant that households borrowing from non-bank lenders incurred an interest premium of up to two percentage points.
- A rate premium of around one percentage point that previously applied to loans for investment housing has been competed away. (Such premiums still apply in some other countries.)
- Today's mortgages have additional features which add to their value (section 3.2). Also 'honeymoon' rates, and other arrangements that reduce the initial cost of acquiring or servicing a loan, are now much more common.

Finally, in examining the role of changes in financing costs on the demand for housing, it is also relevant to look at *expected* as well as current interest rates. A mortgage is a long-term contract. Hence, as evidenced by the shift into fixed rate mortgages that typically occurs when interest rates are expected to rise, borrowing decisions are influenced by perceptions about future financing costs.

Like actual mortgage rates, expected real interest rates — as proxied by the return on indexed long-term government bonds (see figure 3.2) — have trended down since the beginning of the 1990s. However, while real mortgage rates have been roughly stable since the late 1990s, for much of this period, the *expectations* of participants in the bond market were that real interest rates would continue to decline further. Thus, for example, in mid-2003, the real yield on indexed long-term government bonds was about a quarter of one per cent below that in mid-1998 and nearly three-quarters of one per cent below that for much of 1999.

Clearly, caution is required in drawing a link between the behaviour of home buyers and yields on indexed bonds. Nonetheless, the expectations about future inflation and monetary policy settings underlying those yields would presumably influence the behaviour of some participants in the housing market.

Figure 3.2 **Real yields on indexed long-term government bonds**



Note. Yields calculated on a quarterly basis.

Data Source: RBA (2004d).

What effect has cheaper housing finance had on the capacity and incentive to borrow?

Owner occupiers

The fall in nominal interest rates has significantly increased the borrowing capacity of households seeking to purchase a home. Traditionally, borrowing for owner-occupied housing has been capped by a requirement that interest payments, plus the repayment of the loan principal, not exceed 30 per cent of annual disposable income.[1] On this basis, *even without any growth in household incomes* (chapter 4) *or changes in lending practices*, average borrowing capacity over the past five years would have been around 70 per cent higher than for the period from 1983 to 1993 (see table 3.1). Indeed, the current maximum loan to disposable income ratio is more than double its level at the time of the interest rate peak in 1990. Taking account of increases in income (chapter 4), and relative to the average variable mortgage rate over the period 1988 to 1993, overall household borrowing capacity is now around 120 per cent higher in real terms than at the beginning of the 1990s.

[1] The Commission understands that some lending institutions have replaced this traditional 'debt service ratio' with a 'net service ratio' that takes account of differences in the outgoings of households with the same disposable income. While this development potentially has implications for issues such as the effects of upfront charging for infrastructure on the affordability of home ownership (chapter 7), it does not fundamentally alter the analysis of the impacts of lower nominal interest rates on borrowing capacity.

Of course, an increase in borrowing capacity resulting from cheaper finance (or income growth) will not automatically lead to higher levels of borrowing such that total loan repayments are unchanged. Some households might prefer to have lower loan repayments and increase their consumption of other goods and services, or use the savings to invest in other assets.

Nonetheless, cheaper finance will have provided strong incentives for many households to upgrade to better housing, or to enter the market sooner.

- A fall in real interest rates (and/or reduced variability in rates) reduces the opportunity cost of borrowing to buy a house, as well as making the family home a more attractive store for household wealth. An investment in the family home generates a future stream of 'earnings' in the sense that home owners do not have to pay rent. When real interest rates fall (or are expected to do so), the cost of acquiring these future earnings also falls. Hence, there is an incentive to borrow more for housing.
- As people's incomes grow, they generally seek to spend an *increasing* proportion of that income on housing services (chapter 4). To the extent that the traditional '30 per cent of income' borrowing limit has constrained this response to previous income growth, it is likely that many households will have opted to increase borrowing for owner-occupied housing by close to the full amount permitted by the reduction in financing costs.

Investors

Investors in residential property are not constrained by the same maximum repayment-to-income ratio that limits borrowing for owner-occupied housing. This is because investors receive explicit rental income to offset against loan repayments, and a tax deduction if that rental income is less than their borrowing and other costs (chapter 5). Moreover, most private investors in rental properties also have a family residence which serves as an additional (or alternative) form of collateral to secure the loan. Hence, the reductions in nominal interest rates over the past decade or so may not, of themselves, have greatly increased investors' capacity or incentive to borrow.

However, the *initial* effect of a fall in real interest rates will be to raise the total return (rental income plus capital appreciation) on housing investments and thereby stimulate demand. Ensuing increases in prices will push rental yields back down. But these price increases may then encourage a further wave of borrowing, as some investors (and owner occupiers) seek to increase their holding of an appreciating asset. It is this latter motivation for borrowing which can give rise to a housing 'bubble' (chapter 9).

Moreover, while investors in all types of assets have benefited from lower real borrowing costs over the past decade or so, the reduction appears to have been generally larger for investment in housing. As noted above, increased competition in the home lending sector has meant that the one percentage point premium that had previously applied to those investing in residential property was competed away by the mid-1990s.

In sum, cheaper finance has clearly provided strong incentives for both owner occupiers and investors to borrow more heavily for housing. Along with much more readily available housing finance, it has been an important contributor to the surge in borrowing for housing (section 3.3) and the ensuing increases in house prices during the market upswing.

3.2 How has the availability of housing finance improved?

Reductions in interest rates have been accompanied by extensive innovation in the home lending sector, particularly since the commencement of the recent market upswing. According to the Australian Bankers' Association (sub. 164, p. 5), the number of home loan products has more than doubled since 1996.

Many of these innovations have made finance more accessible for households wishing to purchase a home. Notable examples include:

- Mortgage insurance to secure low-deposit loans. While a longstanding feature of the home loan market, its use has increased significantly in recent years.
- High loan-to-valuation ratio (LVR) loans. These allow the borrower to take out a loan to cover all, or nearly all, of the value of a property. The RBA (2003f) reports that around 2 per cent of currently outstanding loans from deposit taking lenders had an LVR between 95 and 100 per cent at inception. Moreover, despite the extra risk, some financiers have been offering 100 per cent LVR loans for owner-occupied housing at standard variable interest rates.
- Home equity loans that allow households to borrow against the family home to purchase a rental property (or for other purposes). Such loans currently comprise around 17 per cent of outstanding loans secured against residential property (RBA 2004d).

Other innovations have reduced the risks and transaction costs of borrowing. For example:

- Most of today's loan products do not penalise borrowers for early or accelerated repayments. Also, there are fewer barriers to loan switching, giving existing

borrowers more scope to take advantage of any interest rate differentials between lending institutions.

- Fixed interest loans, which became more common in the early 1990s, offer protection against fluctuations in interest rates (though the terms for these loans in Australia are short compared with some other countries).
- Products offering more flexible repayment arrangements (such as redraw accounts) have allowed households to more easily accommodate short-term changes in their capacity to service loans.

Much of this recent innovation (see box 3.1) has been driven by increased competition among home lenders, made possible by earlier deregulation of the finance sector. In the early 1990s, the banks and other deposit taking financial institutions moved to expand their home loan portfolios. The subsequent entry of mortgage originators and brokers (see box 3.2) in the mid-1990s provided an even greater boost to competition. For example:

- since 1996, the number of entities offering housing loans has risen from around 90 to more than 130 (ABA, sub. 164, p. 4);
- mortgage brokers are responsible for arranging some 25 to 30 per cent of housing mortgages in Australia (RBA, pers. comm., 9 March 2004); and
- the loan portfolios of mortgage originators have increased tenfold since 1996, and now represent 17 per cent of outstanding home loans (RBA 2003d).

Increased competition (aided by new technologies and more sophisticated credit risk assessment procedures) has also encouraged lenders to rely more heavily on case-by-case assessment of borrowing applications. This has facilitated less conservative lending practices better tailored to the circumstances of individual borrowers, without necessarily increasing the risk for the lender. For example, as previously noted, some lenders now take into account the outgoings as well as the income of the borrower when setting loan limits. According to a number of inquiry participants, greater reliance on case-by-case assessment of borrowing applications has been of particular benefit to part-time and casual workers. (That said, concerns have also been raised about an increase in imprudent lending behaviour — section 3.4.)

In summary, product innovation and changes to lending practices have increased the number of households who can borrow and the amount they can borrow, expanded their choice of lending products, and reduced the costs of borrowing. As many participants pointed out, this has reinforced the incentives for households to take advantage of lower interest rates and to borrow more for housing to meet previously unsatisfied demand.

Box 3.1 Some other recent home loan innovations

Split-purpose loans

These allow a borrower to split a loan into a personal home loan and a loan for investment in a rental property. Their main attraction is that they enable the borrower to focus on repaying the home loan, with the accruing interest cost on the investment component of the loan being tax deductible.

Deposit bonds

Deposit bonds remove the need for a purchaser to provide a deposit at the time of purchase. The issuer of the bond (often an insurance company) guarantees the payment of the deposit at settlement in return for a fee. Deposit bonds are more commonly used for off-the-plan purchases where settlement may be as long as three years from contract exchange.

Non-conforming loans

These loans are provided by specialist mortgage originators (see box 3.2) to borrowers who cannot meet standard lending criteria, or who have poor credit histories. Low documentation mortgages provided without the need for the borrower to detail their income are one example. While such loans generally attract higher charges, they may be particularly useful for people in casual employment. Previously, most borrowers catered for by non-conforming loans had to rely on Cooperative Housing Societies or government sponsored loan programs to obtain finance.

Redraw facilities and offset accounts

These arrangements allow borrowers to redraw money previously deposited in a loan account. This helps households to pay off their loan more quickly, but with the security of access to the redraw facility to deal with unanticipated expenditures.

In a general sense, the impetus to borrowing provided by product innovation applies with similar force to owner occupiers and to investors in rental property.

However, the changes wrought by increased competition among home lenders appear to have been particularly beneficial for investors. According to the RBA (2002, p. 1), lending products for investment in residential property were previously considered 'expensive, inconvenient or hard to acquire'. But finance for such investment is now widely available, with product innovations such as home equity loans, split-purpose loans and deposit bonds explicitly targeted at investors. Indeed, more readily available finance may help to explain part of the increase in negatively geared housing investment during the recent upswing. Moreover, as noted earlier, competition between lenders has eliminated the interest rate premium on housing investment loans, providing an additional benefit to investors over and above the general reduction in lending margins.

Box 3.2 **New entrants to the home lending sector**

Over the past decade, two new institutional groups have made significant inroads in the Australian home lending market.

- *Mortgage originators* (such as Aussie Home Loans and Wizard Home Loans). These institutions are retail or wholesale lenders that raise funds by issuing securities in the money markets (securitisation), rather than primarily lending against deposited monies.
- *Mortgage brokers*. These entities help borrowers find and arrange home loans. They have made it easier for consumers to undertake price comparisons, and their advertising campaigns have raised consumer awareness about financing costs and the different sorts of home loan products available in the market. They have also assisted new lenders (such as mortgage originators) to enter the market by providing marketing and support services. Mortgage brokers are primarily remunerated through upfront and annual commissions from the lending institutions concerned.

3.3 Effects on housing demand and prices

Because house prices are the result of the interaction of many influences on the demand and supply sides of the market, it is not possible to be precise about the contribution of specific developments such as cheaper and more available housing finance.

However, a distinguishing characteristic of the housing market is that most purchases are largely debt financed. Hence, an increase in borrowing capacity as large as that experienced since the early 1990s must be expected to have been an important contributor to the surge in housing-related borrowing over this period, and thereby to the increases in house prices during the recent boom.

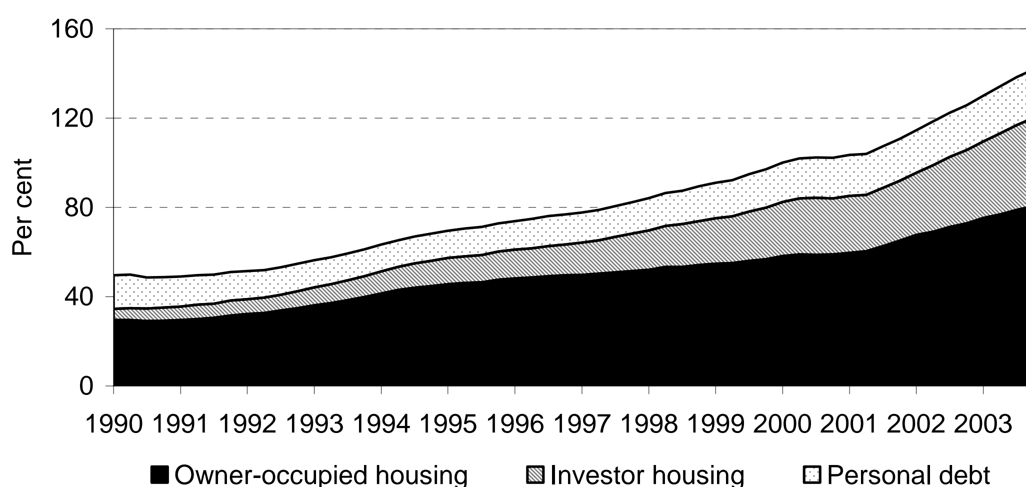
What has happened to household borrowing levels?

Since the beginning of the 1990s, household debt has increased more than three and a half times in real terms. Over the same period, real household disposable income has risen by around 30 per cent. Consequently, household debt as a proportion of household disposable income has increased from 49 per cent in 1990-91 to 143 per cent currently (see figure 3.3).

According to the RBA (sub. 199, p. 14), this increase in household debt has been very rapid by international standards, with the result that Australia has moved from

the lower end of the debt-to-income spectrum to be close to the top. In its latest Monetary Policy Statement, the RBA (2004e, p. 23) also commented that in the December quarter of 2003, Australia's ratio of debt-servicing cost to household income 'is likely to have surpassed' the previous peak at the end of the 1980s when interest rates were at record levels.

Figure 3.3 **Trends in household debt as a proportion of annual household disposable income**



Note. The separation of housing debt is based on bank lending data.

Data source: RBA (2003c).

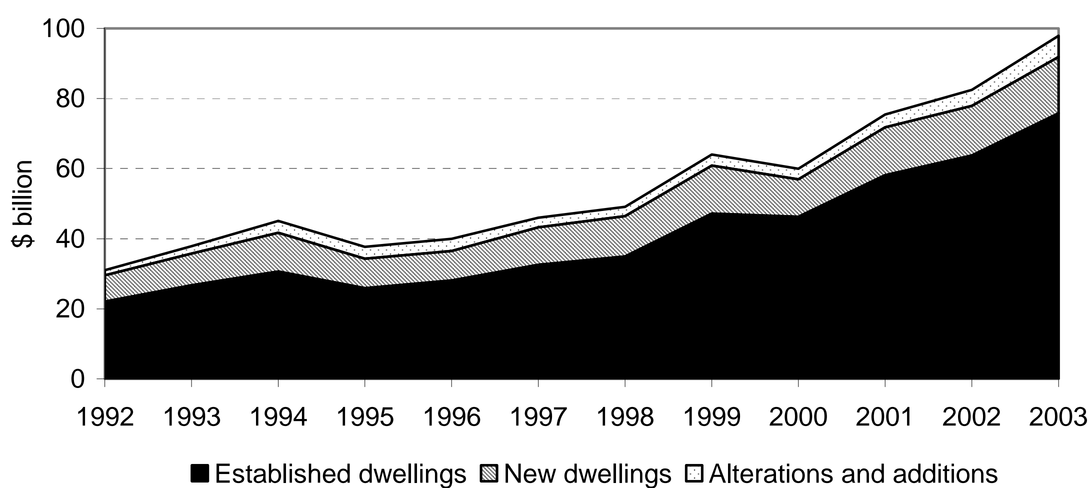
Most of this large increase in household debt has been due to an even more rapid increase in borrowing for housing. Such borrowing has increased more than four-fold in real terms since 1990, meaning that housing-related debt now accounts for 84 per cent of total household debt, up from 69 per cent in 1990. Importantly, however, not all of this housing-related debt is actually spent on housing services. Aided by innovations in the home lending market (see above), an increasing number of households have been using borrowed funds secured against property for other purposes. Indeed, since mid-2001, borrowings secured against property have exceeded total new investment in housing assets (RBA, sub. 199, p. 16).

In dollar terms, most of the increase in borrowing for housing since 1990 has been for owner-occupied dwellings. However, the rate of growth in loans for investment properties has been much higher (figure 3.3). Hence, the share of investment loans in total housing-related debt held by the banks rose from 14 per cent in 1990 to 33 per cent in 2003 (RBA 2003c).

Also, most of the growth in borrowing has been for purchases of existing rather than new homes. In a general sense, this is hardly surprising given that purchases of

existing dwellings account for as much as 80 per cent of total market turnover. Even so, over the past decade, borrowing by owner occupiers for existing dwellings (and for alterations and additions) has increased at more than double the rate of borrowing for new dwellings. Around 81 per cent of the value of finance commitments for owner-occupied housing is now for existing dwellings, with a further 4 per cent being for alterations and additions (see figure 3.4).

Figure 3.4 **Finance commitments for owner-occupied homes**



Note. Excludes refinancing of established dwellings.

Data source: ABS (*Housing Finance for Owner Occupation,* Cat. no. 5609.0).

How much of the increase in borrowing is due to cheaper finance?

As outlined in section 3.1, the fall in interest rates has seen *income constant* borrowing capacity for owner-occupied housing more than double since interest rates peaked in 1990. However, this large rise is still much less than the growth in borrowing for owner-occupied housing, which has more than tripled in real terms over the same period (ABS 2003). Moreover, as noted above, not all households would have wished to exercise fully the increase in their borrowing potential. This led the RBA (sub. 199, p. 34) to conclude that the ' … structural reduction in interest rates … would explain, at most, an approximate doubling in household borrowing relative to incomes … and probably less'.

The even more rapid growth in borrowing for investment in rental housing is similarly hard to explain in terms of the fall in interest rates alone — particularly as borrowing costs also fell for other investments. Also, the surge in investment in residential housing has continued despite the stabilisation in real interest rates since

the late 1990s, and declining rental yields that have ostensibly offset much of the benefit of lower borrowing costs.

More available housing finance helps to explain part of the large borrowing residual, as do income and population growth — the key drivers of demand for housing services in the long term (chapter 4). Moreover, the stronger labour market and more stable interest rates in recent years may have increased the willingness of households to take on debt.

In explaining the surge in borrowing for investment in rental housing, lower returns on other investments (see box 3.3) have seemingly been influential. So too, have aspects of the taxation regime which have reinforced incentives to invest in housing in a period of strong price growth (chapter 5). Not surprisingly, surveys on household investment preferences by the Melbourne Institute of Applied Economic and Social Research showed an increasing preference for real estate between 2000 and March 2003 — though in the latest 2004 survey there was a marked decline.

The attractiveness of housing as an investment is also likely to have encouraged many owner occupiers to borrow and spend more when purchasing or renovating their 'family homes'. Long standing tax preferences for the family home (chapter 5) have added to these incentives.

Further, there has arguably been a 'bubble' dimension to housing demand and the associated increase in borrowing, especially in the past two or three years. While it is impossible to be certain that house prices exceed their 'fundamental' value, the basic drivers of housing demand cannot support an extended continuation of recent price growth, making a softening of prices almost inevitable (chapter 9).

Finally, while the purchase of the majority of housing is initially financed by borrowing, factors that increase the equity that buyers have at their disposal will also put upward pressure on house prices. The First Home Owner Scheme (chapters 4 and 10) is relevant here.

To summarise, cheaper and more accessible finance have been important, though not the only, contributors to the recent surge in housing demand and the ensuing upswing in house prices.

Box 3.3 **Returns on property versus other investments**

Over the past few years, investment in residential property has offered higher pre-tax returns than have been available for other asset classes (see table below).

- The Commission's estimates suggest that, Australia-wide, investment in rental housing delivered a notional pre-tax return (including capital gains) of around 20 per cent per annum in the two years ended June 2003, with even higher returns in some regional housing markets.
- In contrast, depressed equities' markets resulted in negative returns on Australian shares over that same two-year period and on international shares for the three years to June 2003.
- Investment in commercial property (unlisted and listed property), while providing a broadly comparable return from mid-1999 to mid-2001, delivered significantly lower returns in the subsequent two financial years.

Of course, it is post-tax rather than pre-tax returns that drive investment decisions. However, taking tax liabilities into account would not eliminate the large disparity in recent returns on residential property and shares. And, accounting for tax liabilities would *widen* the percentage gap between returns on property and those on bonds and cash. The latter are taxed at normal marginal rates. In contrast, only 50 per cent of capital gains — which have provided the lions' share of recent returns on residential property — are taxed at an individual's marginal tax rate if the property concerned has been held for more than 12 months (chapter 5).

Annual (pre-tax) returns on alternative investments (per cent)

Asset class	*June 2000*	*June 2001*	*June 2002*	*June 2003*
Australian shares	15.5	9.1	-4.7	-1.7
International shares	12.6	-6.0	-23.5	-18.5
Unlisted property	10.9	10.4	9.5	11.1
Listed property	11.9	13.9	14.9	12.1
Australian bonds	6.2	7.4	6.2	9.8
Cash	5.6	6.1	4.7	5.0
Melbourne residential property	12.1	20.9	17.3	25.3
Sydney residential property	13.1	6.3	22.0	20.0
Australia-wide residential property	11.8	14.7	21.3	18.2

Note. These percentage rates of return do not allow for transaction costs associated with investment in residential property, such as stamp duty and real estate agents' charges. While the annualised magnitude of these costs depends on the length of time the investor holds the property, their exclusion means that the estimates in the table overstate the difference between returns on residential property and other assets. However, with investment properties typically held for several years, the extent of this overstatement would not be large.

Sources: Intech (2003); Productivity Commission estimates based on Valuer–General median price data for Sydney and Melbourne, ABS (*House Price Indexes*, Cat. no. 6416.0), and RBA-REIA (2003).

3.4 Some policy issues

Cheaper and more available housing finance have been of considerable benefit to many Australian households, even though ensuing increases in house prices have diluted the gains for more recent home buyers. More generally, the liberalisation of capital markets that has underpinned many of the changes in housing and other financial markets, has been an important contributor to Australia's strong economic performance in recent years.

However, some lending practices may reduce affordability or be otherwise inimical to the interests of borrowers or a stable and secure home lending sector. Some specific concerns raised in submissions are canvassed below.

Are deposit requirements an impediment to home ownership?

For conventional loans attracting standard variable interest rates, borrowers will typically pay a deposit of around 10 per cent of the purchase price. The need to accumulate a deposit, as well as to meet other upfront costs such as stamp duty, make it more difficult for some first home buyers to enter the market.

Nonetheless, given the imperfect information available to both lenders and borrowers, deposit requirements are likely to promote better market outcomes. For example, they:

- help to screen out high risk borrowers and thereby enhance the stability of the home lending sector; and
- benefit approved borrowers by providing an equity margin if house prices fall, or if repayment difficulties arise.

Furthermore, innovation in the home lending market has provided several options to purchasers unable (or unwilling) to meet deposit gaps (section 3.2). Although these options usually require higher loan repayments, they nonetheless allow some households with limited savings to bring forward their home purchases. Also, various government programs assist first home buyers to meet deposit and other upfront costs, including rebates for stamp duties (chapter 5) and grants for first home buyers (chapter 10).

However, although deposit requirements (or other mechanisms that address the additional risks for lenders that attach to highly geared loans) are broadly appropriate, this does not mean that deposit-gap issues are irrelevant from a policy point of view. For example, the effect on the upfront costs of home purchase of possible changes to taxation arrangements is an important consideration (chapter 5).

Further, depending on the perceived social benefits, governments may wish to look at options to help those first home buyers facing a particularly acute deposit-gap problem (chapter 10).

Can regulation of lending practices and property advice be improved?

Especially since the entry of the mortgage originators, all home lenders have become more aggressive in seeking out borrowers and marketing their products. Potential investors in rental property and higher-risk first home buyers have been a particular focus of attention.

Like innovation in lending products, increased competition for customers has generally benefited home buyers. However, there is concern that the incidence of imprudent lending, and misleading investment advice to consumers, is increasing.

Prudential regulation issues

The provision of housing loans by authorised deposit taking institutions is subject to prudential supervision by the Australian Prudential Regulatory Authority (APRA). The Authority (sub. 107, p. 4) said that the current regulatory framework '… underpins a robust and well managed [deposit taking] sector in Australia, in the interests of depositors, while allowing vigorous competition in housing lending'.

However, though some poor lending decisions are inevitable even in a very efficient and well supervised financial system, more aggressive competition for customers does appear to have led to some increase in imprudent lending practices. For example, in its recent 'stress-testing' assessment of the deposit taking institutions, APRA said that though most of these institutions have adopted prudent and rigorous lending practices, its supervisory visits had identified a growing number of practices that were 'questionable in their prudence' (2003a, p. 17). Furthermore, APRA's review did not cover non-deposit taking institutions, such as mortgage originators, which hold about 17 per cent of the value of outstanding home loans, but do not have to comply with the same prudential regulation as deposit taking lenders. More generally, it was put to the Commission that imprudent lending is the flip-side of concerns evident in some quarters about excessive borrowing for housing.

Against this backdrop, APRA is currently examining two specific aspects of the prudential framework applying to deposit taking lenders:

- the criteria that housing loans by deposit taking lenders must satisfy to qualify for the concessional 50 per cent risk weighting. (Because of low default rates on residential property in Australia, the minimum capital backing on housing loans is half of that required for other loans to individuals and businesses); and

- whether to implement proposed international reforms to capital adequacy requirements, commonly known as Basel II, that would further reduce the capital backing required for lending for residential property by these institutions.

In its Discussion Draft, the Commission sought comment on whether current prudential requirements for deposit and non-deposit taking lenders are appropriate and, if not, what changes are required. In response, several participants reiterated general concerns about a perceived deterioration in prudential standards. More specifically, the Credit Union Services Corporation (Australia) Ltd (CUSCAL) argued:

> … if mortgage originators or other non-ADIs wish to position their products to compete in the housing finance and associated lending markets, they should be subject to comparable regulatory regimes or supervisory controls that protect borrowers to at least the same standard as ADI lenders. (sub. DR308, p. 3)

And, Nigel Fitzpatrick (sub. DR228) argued that a reduction in the risk weighting for housing loans is unnecessary, and proposed that APRA and the deposit taking institutions both be subject to various new prudential obligations and information collection requirements.

Assessment of the merits of these more specific proposals clearly lies well beyond the purview of this inquiry. Accordingly, the Commission has forwarded them on to APRA for consideration as part of the Authority's current review of risk weighting and related issues.

That said, the concerns underlying these sorts of proposals illustrate the importance of effective prudential and regulatory oversight and the need for careful assessment before any liberalisation of current requirements occurs. Such liberalisation could have significant impacts on the ability and willingness of the deposit taking institutions to lend for housing, with flow-on implications for house prices. Ensuring that there is an effective regulatory framework for non-deposit taking lenders is similarly important, particularly if this sector's share of the home loan market continues to grow.

At the same time, it is important that such prudential and regulatory frameworks do not unduly stifle the sort of innovation in lending practices and products that, in recent years, has brought home ownership within the reach of a new group of Australian households. In this regard, CUSCAL (sub. DR308, p. 3) expressed concern that attempts to tighten regulatory supervision of non-deposit taking lenders might inadvertently lead to additional and unnecessary controls on deposit taking institutions.

Reducing the incidence of misleading practices

Like lenders, borrowers can also make poor decisions. For some consumers, assessing the array of lending products now available, let alone making well-informed judgments about the future course of interest rates etc, may be very challenging. Hence, instances of excessive exposure to risk, inappropriate loan selection and over (and under) borrowing are inevitable.

Various market-driven initiatives are helping consumers to make more informed decisions. For instance, information on home loan products is now much more widely available. Also, requirements for lenders to provide consumers with specific information central to borrowing decisions is mandated in several pieces of legislation.

Nonetheless, concerns about misleading practices remain, particularly in relation to the activities of mortgage brokers and some property investment advisers.

State and territory governments are currently developing proposals to provide for uniform regulation of the mortgage and finance broking industries. Options being canvassed by a working group that will report shortly to these governments include the introduction of minimum licensing requirements, and probity and disclosure standards. In the interim, the Mortgage Industry Association of Australia has introduced conduct and disclosure standards for its members.

Another working party of state and Australian government representatives (including from the Australian Competition and Consumer Commission and the Australian Securities and Investment Commission (ASIC)) will report shortly on options for introducing a new national or state-level regulatory scheme for property investment advice. Amongst other things, the working group's terms of reference asked it to report on the nature and extent of property investment advice in Australia, the adequacy of current regulations and the potential impact on consumers of existing industry practices. This assessment follows a previous review by ASIC (2000), which found that the legislation in this area was inadequate, especially in relation to competency requirements and the disclosure of commissions.

In responding to the Discussion Draft, the Real Estate Institute of Australia (sub. DR279, p. 3) emphasised that real estate agents are already subject to extensive state and territory regulation and various Australian Government legislation covering the provision of investment advice. It went on to note that the Joint Communiqué released by the working party in August 2003 (Ministerial Council on Consumer Affairs 2003) indicated that the review was prompted by '… concern at the operation of marketeers and property investment advisers and the detrimental impact they have on unwary customers'.

In the Commission's view, some recent well publicised episodes have highlighted the importance of appropriate regulation of property investment and related financial advice. Indeed, given the magnitude of the commitment involved in buying a house, the consequences for individuals of poor purchasing or financing decisions made on the basis of incompetent or misleading advice, can be very serious. Further, overly 'aggressive' marketing of real estate has the potential to increase house price volatility, thereby affecting participants in the housing market more generally.

However, like prudential and regulatory oversight of lending institutions, there is a need for balance in such regulation. For example, regulation that significantly reduced the scope for mortgage brokers and property investment advisors to respond flexibly and expeditiously to the needs of clients, could disadvantage rather than benefit home buyers. Hence, it is important that policy initiatives emerging from the current review exercises are the subject of rigorous benefit–cost analysis within the agreed regulatory impact statement process.

4 What role for other demand-side forces?

Findings

- A sustained period of strong economic growth has underpinned housing demand since the early 1990s. This has contributed significantly to the pressure on house prices over the life of the recent boom.
- Growth in immigration since the mid-1990s has been an important contributor to underlying demand, particularly in Sydney and Melbourne.
  - However, the pick-up in immigration has been partially offset by a slower rate of natural increase in the resident population, so that overall population growth has not been a key driver of recent rapid increases in house prices.
- The trend to smaller households is also increasing the underlying demand for housing, but this is a long-term development that is unlikely to have contributed significantly to rising prices during the recent upswing.
- While the First Home Owner Scheme has brought forward some housing demand and thereby contributed to increased prices in the short term, the effect has been small.

Increases in housing demand resulting from cheaper and more 'accessible' housing finance, in a 'supportive' tax environment (chapter 5), explain a substantial part of the rise in house prices since the mid-1990s. Other demand-side forces have, however, also played a role. These include:

- income growth;
- population (including immigration) and other demographic changes; and
- direct government assistance for first home buyers.

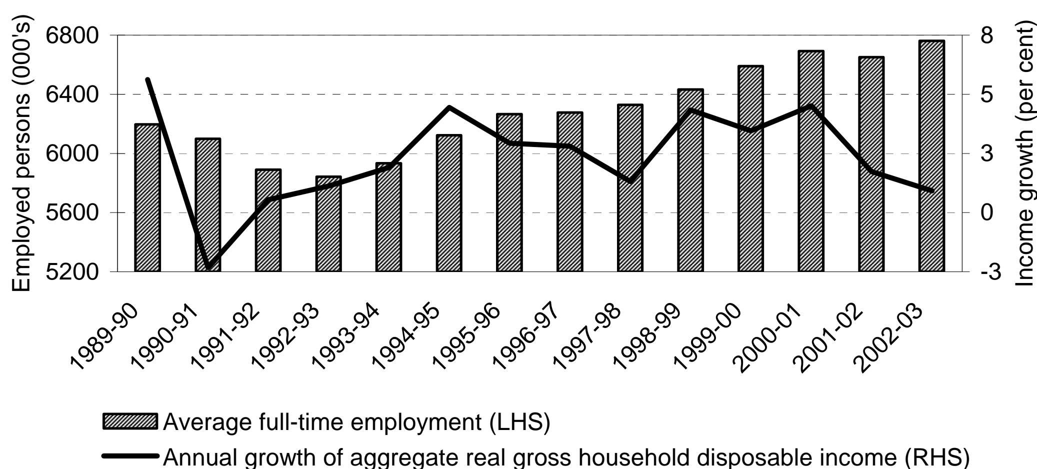
Economic and population growth, along with other demographic changes, have increased demand for housing throughout the 1990s, while direct government assistance has added to cyclical price pressures.

4.1 Economic growth

Over the last decade or so, Australia has experienced sustained strong economic growth (see figure 4.1). Since 1992-93:

- the number of people in full-time jobs has risen by around one million (growing by an average rate of 1.5 per cent per year);
- aggregate household disposable income has increased by 32 per cent in real terms (2.8 per cent per year); and
- real disposable income per household has increased by an average rate of 1.2 per cent per year.

Figure 4.1 **Income growth and employment**



Data source: Productivity Commission estimates based on RBA Bulletin Statistical Tables.

With rising employment and incomes, more people have the financial capacity and security to purchase their first home, while more existing home owners will seek to trade up to higher quality housing.

Studies based on Australian data, which have focused on aggregate demand-side pressures alone, have estimated that, in the long term, real house prices might increase by 1.5 per cent or more for each one per cent increase in aggregate real income (IMF 2003; Sutton 2002; Tu 1999). These estimates imply that income growth could explain roughly half of the almost 80 per cent increase in real house prices during the recent upswing.

These estimates, however, seem too high by international standards. For example, in most European countries, house prices tend to rise less rapidly than incomes (UK Treasury 2003, p. 32). Moreover, disentangling the effects of income and

employment growth from other demand-side forces, such as lower interest rates and population growth, is complex. Changes in the *distribution* of income also affect the demand for housing. In addition, the extent to which increased demand for housing leads to higher house prices depends on the responsiveness of housing supply (chapter 6).

These methodological problems mean that not too much store can be placed on such estimates. In view of the limitations of the relevant econometric techniques and time constraints, the Commission did not attempt to derive its own estimates of the income elasticity of house prices.

Nevertheless, it seems incontrovertible that income and employment growth have underpinned growth in housing demand in Australia since the early 1990s, which in turn has placed upward pressure on prices.

4.2 Population and other demographic changes

The strong growth in aggregate incomes over the past decade is partly the result of higher income per capita as productivity has improved (Banks 2003). Part of the *aggregate* income growth, however, is attributable to population growth. In this sense, the influences of income and demographic changes are entangled. Nevertheless, it is useful to examine population and other demographic influences in their own right, partly because there is a view that immigration has been an important contributor to the housing boom, and partly because some demographic influences, such as changes in household size, are only loosely related to income, if at all.

Throughout the 1990s and the early 2000s, Australia's 'resident population' (explained in box 4.1) increased by about 1.2 per cent per year, down from an annual rate of 1.5 per cent in the 1980s. Thus, as David Tollner noted, population growth was moderate and stable during a period when growth in house prices varied dramatically (sub. 87, p. 2). This suggests that population pressures have not been a major cause of the recent acceleration in house prices across the country, although rapid growth in overseas visitors such as students may have boosted demand for rental housing (see Reserve Bank of Australia, sub. 199, p. 28).

Box 4.1 **Coverage of resident population**

In responding to the Discussion Draft, Rob Keane (sub. DR232) contended that the ABS population growth figures omit certain household formation groups — namely, overseas students and business migrants who do not continuously stay for 12 months in Australia — and that this may have implications for the assessment of housing demand.

The Commission recognises that the ABS resident population estimates have limitations when used for assessing housing demand.

In the census, the *usual residence* rule is used to estimate the resident population. Essentially, all people in Australia on the census date are included in the count of resident population, except for *short-stay visitors* who usually live in another country and are visiting Australia for less than a year.

Some short-stay visitors who are not included in the resident population estimates may have housing requirements similar to those counted as part of the resident population. For example, an overseas student attending a short course (for less than 12 months) in Australia could rent a house or an apartment, rather than stay in a hotel. (This group of short-stay visitors is a subset of the visitors referred to by Rob Keane.)

To calculate intercensal changes in the resident population, the ABS measures the number of arrivals and departures of residents, permanent migrants and visitors (see box 4.2) to estimate net immigration. Of the visitors, only those who stay or depart for a continuous period of 12 months or more are included as a change to the resident population. The movements not included as net migration may include:

- overseas 'residents' who spend a considerable amount of time in Australia but for never more than 12 months at a time; and
- Australians who live overseas but are never continuously absent for longer than 12 months.

Given the significant influx of foreigners coming to work or study in Australia in recent years, it seems highly likely that short-stay visitor movements may have added to the demand for housing. However, the Commission is unaware of any research that quantifies these effects.

Sources: ABS (*How Australia Takes a Census*, Cat. no. 2903.0; *Australian Demographic Statistics*, Cat. no. 3101.0, June Quarter 2003 issue); ABS pers. comm., 2 February 2004.

However, the impacts of population growth on the demand for housing in particular cities and regions are subtle and complex, and understanding them requires analysis not only of aggregate figures, but also of:

- the sources of population growth, and in particular the extent to which it derives from natural increase or immigration;
- the composition of arriving immigrants;

- movements of people among regions and cities; and
- changes in household formation.

But as discussed below, accounting for these complexities does not invalidate the basic conclusion that factors such as cheaper and more accessible finance and income growth have been more important contributors to recent house price growth than population pressures.

In this regard, it is important to distinguish between changes in demand for additional dwellings and increased demand for better located and higher quality housing. As discussed in earlier chapters, most of the added pressure on prices has come from households seeking to buy higher quality and better located dwellings.

Population

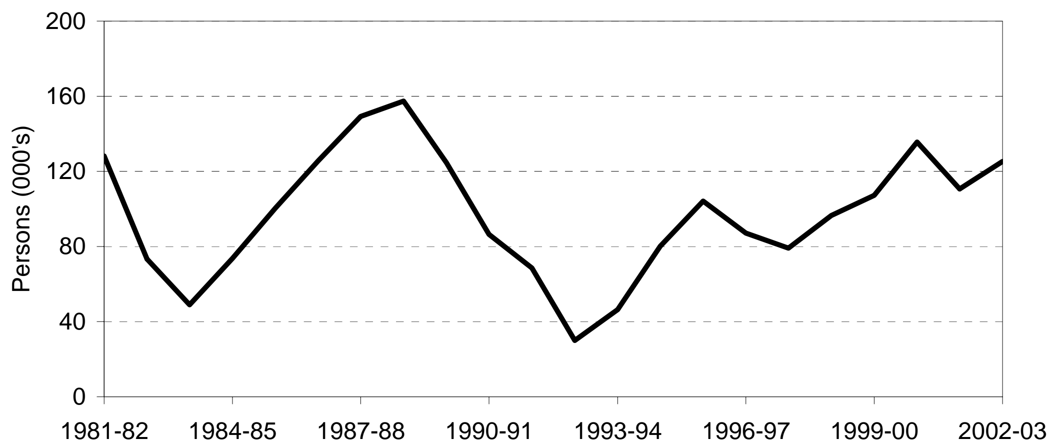
As noted above, some consider that immigration has been a key driver of population growth and housing demand in the past few years. For example, the NSW Government (sub. 187) regarded immigration as the dominant source of additional demand for new dwellings in that state, and in Sydney in particular. Similarly, Birrell and Healy (2003, p. 55) suggested that '… there is little doubt that a reduction in the national immigration intake would improve housing affordability in Sydney'.

Immigrant and visitor arrivals

Net immigration is calculated by the ABS as the excess of permanent and long-stay (more than a year) visitor arrivals over permanent and long-stay departures. It is an important component of population growth in Australia and has increased from a low point in 1992-93 (see figure 4.2). The ABS estimates that in 2002-03 there was a net gain of 125 000 persons through permanent and long-term movements. This estimated net intake is more than four times the level in 1992-93, double the average net immigration level in the first half of the 1990s, and approaching the previous peak reached in 1988-89.

While the extent of the recent increase may be overstated by ABS net immigration estimates (see box 4.2), immigration has clearly added to demand. Moreover, housing demand will have been boosted in recent years by short-stay visitors who are excluded from the estimates of net immigration, but who have similar housing requirements to the resident population (see box 4.1).

Figure 4.2 **Net immigration to Australia**



Data source: ABS (*Australian Demographic Statistics*, Cat. no. 3101.0).

The precise effect of immigration on housing demand depends on the composition of arrivals and where they settle.

Composition of immigrant arrivals

Early in the 1990s, two permanent settlers arrived for every long-stay visitor. By the early 2000s, there were twice as many long-stay visitors as permanent settlers. Long-stay visitors such as students and working holiday makers are less likely to have dependants and so an increase in their number is likely to add more to the demand for accommodation than a similar increase from natural population growth or permanent immigration. Moreover, while some purchase homes, most seek rental housing, especially apartments or flats near schools, universities and workplaces (typically in the major cities).

Hence, the shift in the composition of immigration towards long-stay visitors may well have contributed to the surge in investment in rental housing, particularly in Sydney, which absorbs most new arrivals. Indeed, a recent small scale survey indicated that nearly half of all business visitors holding long-stay visas live in rental accommodation in Sydney (see box 4.3).

Box 4.2 **Measuring net immigration**

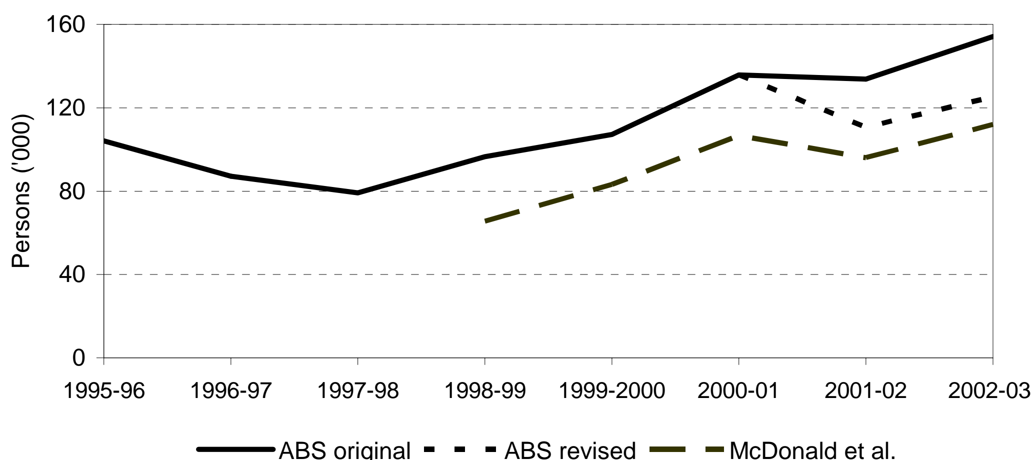
To measure net immigration, the ABS estimates the number of long-stay arrivals (and departures) for residents and visitors who stay (and depart) for more than 12 months (see box 4.1). The length of stay is identified from incoming and outgoing passenger cards, with indirect estimates made of the number of people who subsequently change their duration of stay in Australia or time away from the country.

McDonald and Kippen (2002), however, suggested that the methodology used by the ABS systematically overstates the number of long-stay visitor arrivals after 1998 because of some multiple entries by the same people. In a subsequent paper, McDonald, Khoo and Kippen (2003) estimated that, over the five years from 1998-99, the number of net long-stay arrivals was about 40 per cent lower than the preliminary official estimates. According to their estimate, net immigration has increased by just 1.1 per cent per year since 1995-96.

The ABS do not fully accept McDonald, Khoo and Kippen's estimates because they do not have regard for Australian residents who indicate, when leaving the country, that they will have a short term (less than 12 months) absence but in practice stay away for longer, and vice versa. However, the ABS has revised downwards its original net intake estimates for 2001-02 and 2002-03 by 26 000 on average for each year. Estimates for earlier years were not revised.

According to the latest ABS figures, net immigration has increased by 2.7 per cent per year since 1995-96 (see figure below).

Net immigration to Australia: alternative estimates



Data sources: ABS (*Australian Demographic Statistics*, Cat. no. 3101.0, March Quarter 2003 and June Quarter 2003); McDonald, Khoo and Kippen (2003).

Box 4.3 **Location and housing arrangements of long-stay business visitors**

The results of some preliminary analysis on a limited sample (377 records) of Temporary Business Entry (Long-stay) Visa holders undertaken by Professor Peter McDonald at the Australian National University Research School of Social Sciences, indicate that approximately:

- 50 per cent live in Sydney;
- 20 per cent live in Melbourne;
- 84 per cent live in rental accommodation;
- 12 per cent live in their own home; and
- 4 per cent live in an existing household.

Source: Professor McDonald (pers. comm., 16 March 2004).

The effect on housing demand of permanent settlers depends on whether they are coming to join existing households in Australia. For example, immigrants under the family reunion program (which includes the spouse or fiancé, children and parents of an Australian citizen) account for about 40 per cent of all permanent settlers requiring visas (DIMIA 2003). Earlier studies indicated that these families generally resided with the Australian citizen they were joining, at least in the short term (Tonkin, Williams and Ackland 1993). However, data are unavailable on the current housing demand of these migrants.

Population movements to states and territories

The distribution of arriving immigrants between jurisdictions and between capital cities and regional areas has changed little over the last decade, with NSW standing out as the largest recipient:

- NSW and Victoria received most permanent settlers (40 per cent and 24 per cent respectively in 2001-02).
- Most long-stay visitors stayed in NSW (42 per cent) or Victoria (23 per cent).

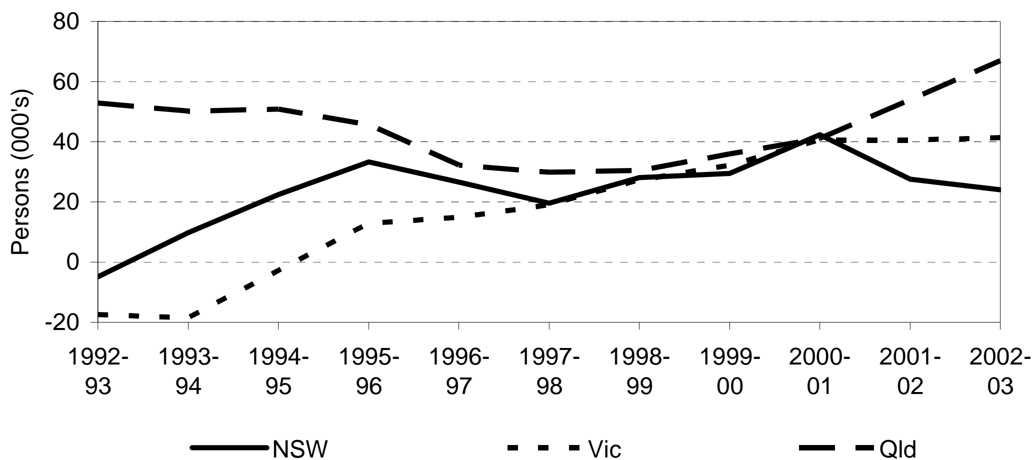
Most immigrants settle in capital cities. According to the 2001 Census data, Sydney, Melbourne, Adelaide and Perth received 90 per cent or more of their state's intake. The corresponding figures for Brisbane, Hobart and Darwin were in each case about 60 per cent.

This suggests that the initial pressure on housing demand from immigration is likely to be experienced mainly in the capital cities, particularly in Sydney. However,

these effects may be diluted as residents (including previous immigrants) move around Australia, partly in response to regional differences in house prices.

At the state and territory level, as well as natural increase, population growth includes net immigration and net interstate migration. The combined effects of these two latter components of growth is shown in figure 4.3 for NSW, Victoria and Queensland. All experienced net inflows of population over the life of the current housing boom, with the strongest growth occurring in Victoria.

Figure 4.3 **Net population movements to selected states**



Data sources: ABS (*Australian Demographic* Statistics, Cat. no. 3101.0; *Migration*, Cat. no. 3412.0).

Total population growth in states and regions

The rate of natural increase in the resident population has been declining across Australia. Hence, despite higher national immigration, annual population growth in most cities and states has been either lower or only marginally higher since the start of the recent housing boom, than it was in the preceding five year period (see table 4.1). The exceptions are Melbourne and country Victoria, and WA (except Perth), which have experienced a pick-up in population growth.

Table 4.1 **Average annual population growth rates, 1991 to 2002**

Location	*1991 to 1996*	*1996 to 2002*
	per cent	per cent
Sydney	1.1	1.2
Rest of New South Wales	0.9	1.0
Melbourne	0.8	1.2
Rest of Victoria	0.2	0.9
Brisbane	2.3	1.8
Rest of Queensland	2.6	1.7
Perth	1.7	1.5
Rest of Western Australia	1.0	1.5
Adelaide	0.4	0.5
Rest of South Australia	0.3	0.5
Hobart	0.5	0.2
Rest of Tasmania	1.7	-0.2
Australian Capital Territory	1.3	0.8
Northern Territory	1.9	1.4
Australia	**1.2**	**1.2**

Sources: ABS (*Population Growth and Distribution*, Cat. no. 2035.0; *Australian Demographic Statistics*, Cat. no. 3101.0).

This suggests that population pressures in themselves have not been a major driver of the recent strong upswing in house prices across Australia. As the NSW Government commented:

> Population growth is the key factor leading to household formation and the underlying demand for housing. The rate of population growth has been above average in Sydney and NSW. However, the net increase in the number of households (or the underlying demand for housing) has not significantly diverged from the long-term trend and does not in itself explain the degree to which prices have risen. (sub. 187, p. 9)

This highlights again that increased demand for better quality and better located dwellings, rather than for more dwellings, has been the primary driver of prices in the recent upswing.

Of course, in the absence of higher immigration, population growth would have slowed by more and with it, the underlying demand for new housing, especially in Sydney. This would have tended to offset the upward pressure on house prices coming from, amongst other things, economic growth and cheaper finance.

In making this point, the Commission is not suggesting that immigration policy should be used to influence housing demand or affordability. Immigration policy obviously needs to be determined by broader considerations.

Household formation

The number of dwellings required nationally will grow more rapidly than the aggregate population if the average number of residents per household falls. This indeed is what has happened during the 1990s and into the 2000s. In this period, the number of households has increased by 1.8 per cent per year, while the population has grown by 1.2 per cent, as average household size has declined from 2.8 to 2.6 persons. According to BIS Shrapnel (2003), the shift to smaller households accounted for approximately 40 per cent of the growth in the number of households in the first half of the 1990s and 30 per cent in the second half.

The link between population growth and household formation is influenced by a large number of social and demographic factors. For example, the population is ageing (see box 4.4), the incidence of family breakdown is growing, the birth rate is declining, more people are remaining single, and young adults are staying at home for longer. Some of these factors encourage household formation and some work against it. However, as the household formation figures show, on balance, social and demographic trends are increasing the underlying demand for housing.

Box 4.4 **Our population is ageing**

The rates of growth in Australia's population vary across age groups, and over the past decade or so have been highest among those older than 44, who are more likely to be trading up to more expensive houses than entering the market for the first time (see table below). Since 1996, there has been virtually no population growth in the 25 to 34 year old age group, which is likely to include most first home buyers (see appendix B).

Annual percentage rates of population growth by age group

Period	*Aged 25 to 34*	*Aged 35 to 44*	*Aged 45 to 54*	*Aged 55 and over*
1991 to 1996	0.3	1.4	4.2	1.8
1996 to 2003	0.1	0.9	2.3	2.9

Source: ABS (*Population by Age and Sex, Australian States and Territories*, Cat. no. 3201.0).

That said, changes in household formation occur slowly. Hence, while the decline in the average household size may increase the demand for housing over the long term, it is unlikely to be a significant contributor to the recent sharp increase in house prices above the long-term trend.

Impact of population and household formation on underlying demand for new dwellings

The conclusion that population growth and household formation trends have not been major drivers of the recent national increase in house prices is supported by estimates of the underlying demand for dwellings. According to BIS Shrapnel (2003), at the national level, underlying demand for new dwellings (estimated as a function of trend growth in the resident population and household formation) fell slightly in the second half of the 1990s (see table 4.2).

Table 4.2 **Estimates of underlying demand for additional dwellings, 1980s and 1990s**

	NSW	*Vic*	*Qld*	*WA*	*SA*	*Tas*	*ACT*	*NT*	*Australia*
					Annual average ('000 units)				
Mid-1981 to mid-1986	39.7	31.3	31.5	16.1	10.2	3.2	2.4	2.3	136.8
Mid-1986 to mid-1991	39.2	34.2	32.4	18.2	10.7	3.2	2.8	1.1	141.7
Mid-1991 to mid-1996	43.0	26.9	41.0	17.9	8.7	2.9	3.1	1.4	145.0
Mid-1996 to mid-2001	45.0	34.0	32.0	18.0	7.5	1.8	2.1	1.2	141.5
Mid-2001 to mid-2003[a]	49.1	43.2	41.6	18.0	7.5	2.0	2.0	0.7	164.7

Note. Estimates of underlying demand are based on changes to the estimated resident population. This will underestimate the underlying demand because housing demand by visitors, particularly short-stay visitors, is not taken into account (see box 4.1). [a] Figures for the period mid-2001 to mid-2003 are based on estimates of net immigration that differ from the latest revised ABS estimates (see box 4.2).

Source: BIS Shrapnel (2003).

The Reserve Bank of Australia pointed out that estimates of demand for new dwellings have picked up more recently (sub. 199, p. 29). The Housing Industry Association (sub. DR260, p. 6; trans., p. 90) also referred to BIS Shrapnel's higher estimates of underlying demand for the period mid-2001 to mid-2003 (see table 4.2). However, in estimating net immigration, BIS Shrapnel used the original ABS estimate for 2001-02 and its own estimate for 2002-03, which turned out to be on average 20 000 visitors per annum higher than the latest revised ABS estimates. This would seem to explain a large part of the estimated increase in underlying demand early in the 2000s.

Even so, as noted above, housing demand appears to have been boosted by growing numbers of business visitors and students who are not included in the resident population estimates.

4.3 Grants to first home buyers

The sources of influence on housing demand and prices described thus far are permanent features of the social and market environment. A recent additional influence on housing demand is the First Home Owner Scheme (FHOS), which has been in place since July 2000. Under this scheme, eligible first home buyers can apply for a grant of $7000 when they buy a new or established dwelling.

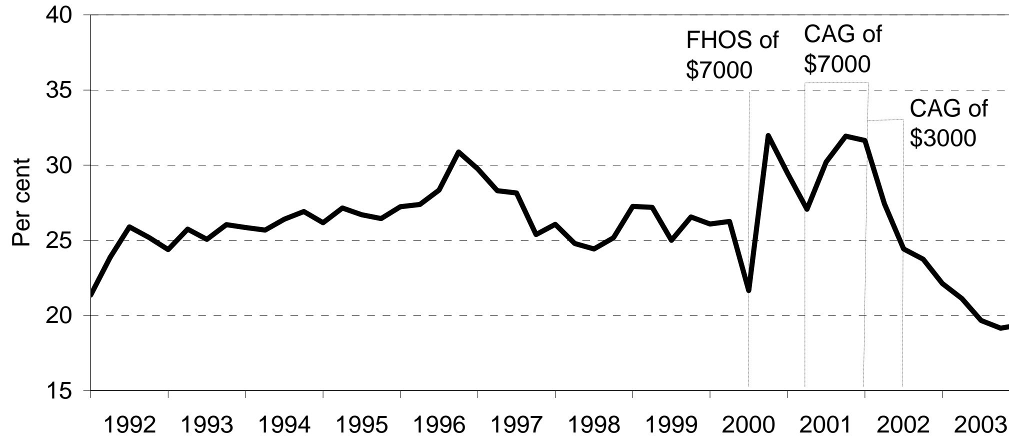
At the time the grant was introduced, the stated rationale was to compensate for the increase in house prices associated with the implementation of the Goods and Services Tax (GST). This support for first home buyers led to an increase in their demand. However, this was insufficient to offset the slump that followed when many other house buyers brought forward the purchase or construction of new dwellings into the first half of 2000 to avoid the GST.

As a result, and notwithstanding the grant, in 2000-01, dwelling commencements fell by about 30 per cent, the largest annual decline since 1975. In response, the Australian Government introduced the Commonwealth Additional Grant (CAG), which provided an extra $7000 to those FHOS recipients who were purchasing a newly constructed dwelling. Initially to apply from March 2001 to December 2001, the scheme was subsequently extended until 30 June 2002, with the additional grant reduced to $3000. The original $7000 grant under the FHOS remains in place for eligible first home buyers.

Impact on house price trends

From July 2000 to January 2004, around $4.3 billion was provided to over 550 000 home buyers through the initial and additional grants (Australian Government Treasury, pers. comm., 19 March 2004). Both the first home buyers' share of total approvals and the number of loan approvals to first home buyers rose markedly around the times that the original and additional grants were introduced, subsequently falling sharply (see figures 4.4 and 4.5). Thus the grants appear to have 'pulled forward' house purchases that would otherwise have occurred somewhat later (chapter 10).

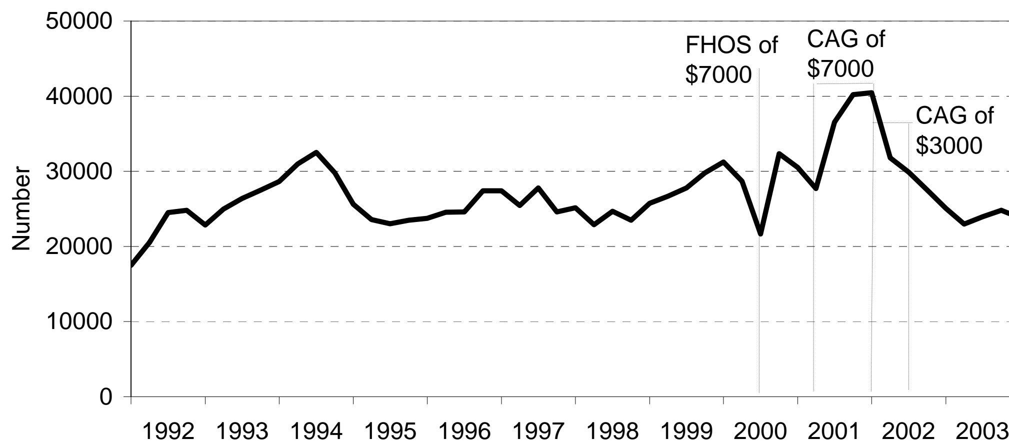
Figure 4.4 **Loan approvals to first home buyers as a proportion of total approvals**



Note. Excludes refinancing of established dwellings.

Data source: ABS (*Housing Finance for Owner Occupation*, Cat. no. 5609.0).

Figure 4.5 **Number of first home buyer dwellings financed**



Note. Excludes refinancing of established dwellings.

Data source: ABS (*Housing Finance for Owner Occupation*, Cat. no. 5609.0).

The extent to which these grants assisted recipients depends on how much house prices have risen in response to the resultant increase in demand. This, in turn, will depend on the responsiveness of supply.

In an extreme case, if there were no capacity to increase the supply of housing in the face of a jump in demand, the entire grant could be capitalised into house prices,

lifting the price of a property valued at $250 000, for example, by a little under 3 per cent. However, given that median house prices have increased by 18 per cent per year since the grant was introduced, it is clear that the FHOS has been at most a minor contributor to the recent surge in prices.

Over the long term, as supply has time to respond to demand pressures, the grant is likely to have even less impact on house prices. That is, the increase in demand will encourage additional supply rather than simply boost prices. However, the increase in supply is also likely to be small, given the relatively low value of the grant in relation to house prices and its limitation to one group of purchasers. The impact of the FHOS, and in particular whether it has materially increased home ownership rates, is discussed in chapter 10.

5 The role of taxation

Findings

- The burden of taxes affecting housing is generally shared between buyers and sellers, regardless of who initially pays.
- Increased taxes such as the GST and stamp duty have played only a minor direct role in recent house price growth.
- However, stamp duties are an obstacle to first home ownership, as well as inhibiting the reallocation and adaptation of the housing stock.
  - Governments need to consider how best to reduce reliance on stamp duties, in favour of more efficient alternative sources of revenue.
  - If progress is not made in this regard, tax-on-tax anomalies involving stamp duties would then need to be addressed.
- Income tax ‘preferences’ for owner-occupied housing, including the exemption from capital gains tax, may have led to over-investment in housing.
  - But it is unclear whether any changes to promote neutrality of treatment would yield significant gains to the community, given administrative complexities, compliance and adjustment costs, and the possible loss of social benefits from home ownership.
- Other aspects of the personal taxation regime — including negative gearing rules, ‘capital works’ deductions, the 1999 change to capital gains tax, and high marginal income tax rates — have combined to magnify the attractiveness of investing in residential property during the recent upswing in house prices, thereby adding to price pressures.
  - These features of the income tax system do not in principle favour private investment in rental housing over other passive investments, such as in equities or commercial property.
  - Nonetheless, it seems that they may be contributing to inefficient outcomes in housing and other asset markets. Hence they should be the subject of a broader review, focusing in particular on the capital gains tax regime.

In commenting on affordability issues, many inquiry participants cited the stamp duty ‘windfall’ for state and territory governments from rising house prices. There was also widespread concern with Australian Government taxation arrangements. It was claimed that the recent introduction of the goods and services tax (GST) had increased house prices. Further, changes to the capital gains tax (CGT) regime, coupled with long standing negative gearing arrangements, were seen to have

contributed to higher prices through encouraging greater levels of investment in housing.

The next section briefly describes some of the main features of taxation arrangements affecting housing. The chapter then examines the possible price effects of the recent tax changes and of the tax arrangements affecting housing more generally. Finally, some possible improvements to aspects of housing taxation are discussed, with attention drawn to some general components of the tax regime impinging on housing demand and prices. In some areas, the Commission is recommending that potential reforms be subject to further review, including examination of the administrative consequences, the transitional and adjustment costs, and broader economic effects.

5.1 Current taxation arrangements

Australian Government tax policies affecting housing include the taxation of rental income, deductibility rules for expenses (including negative gearing), CGT and the GST. (The First Home Owner Scheme, introduced in the first instance to offset the effect of the GST on the cost of new dwellings, is discussed in chapters 4 and 10.) At the state level, stamp duties and land taxes are the two main housing-related taxes.

Tax exemptions and concessions also influence housing demand and supply. For instance, the Australian Government does not tax the imputed rental income of owner occupiers (see below), nor does it impose CGT on the principal residence. State and territory governments provide various stamp duty concessions for first home buyers and land tax exemptions for owner occupiers.

Australian Government taxation arrangements

Rental income and deductibility rules

Like income derived from other sources, rental income from residential investment property is included in a taxpayer's assessable income and taxed at the applicable marginal rate. A significant proportion of taxpayers — about 17 per cent by one recent estimate (chapter 2) — declare rental income. As with other forms of investment, investors can deduct allowable associated costs incurred in earning that income under the general deduction provisions. Such costs may include: interest on borrowings; depreciation (at various rates) of fixtures and fittings such as blinds, carpets, furniture and electrical appliances; as well as 'capital works deductions'.

This latter item effectively represents an allowance for depreciation on the building itself, as well as on alterations and structural improvements. For construction started after 15 September 1987, the rate of deduction per income year is 2.5 per cent, based on the original construction cost. A rate of 4 per cent applies to construction started between 22 August 1984 to 15 September 1987.

Housing-related deductions in excess of rental income can be set against other sources of income (referred to as ‘negative gearing’). In 2000-01, 7 per cent of taxpayers had negatively geared property investments, compared with 6 per cent in 1995-96 just prior to the commencement of the recent housing boom (ATO 2003). Moreover, in 2000-01 (and some previous years), total deductions claimed for rental properties exceeded reported rental income. Although data are not yet available, recent strong growth in investment in rental housing and historically low rental yields, suggest that this would also have been the case since then. Negative gearing arrangements also apply to some other forms of investment, such as shares.

The implicit or ‘imputed’ rental income accruing to owner occupiers (in effect, the rent which owners would need to pay to themselves if they rented their own houses at market rates) is not subject to tax — unlike actual income from other property investments — but nor can owners claim tax deductions for costs such as interest payments, maintenance and depreciation. The tax treatment of imputed rental income is not of course unique to housing — individuals do not pay tax on imputed income from other assets, such as motor vehicles.

Capital gains tax

Capital gains tax applies to many classes of assets, including housing, acquired after September 1985. It is payable when assets are sold rather than on an accruals basis. The taxable amount of capital gain is added to income in the year of sale and taxed at the applicable income tax rates. The taxpayer’s main residence is exempt from CGT.

Initially CGT was levied on the full estimated real capital gains (after allowing for inflation). But since 21 September 1999, it has been levied on nominal capital gains. Under the new arrangements, individuals and trusts receive a discount of 50 per cent for assets (including investment housing) held for longer than 12 months, while superannuation funds receive a 33 per cent discount. However, no discount applies for companies. Phasing arrangements apply.

The current CGT discount arrangement was introduced by the Australian Government after consideration of the Ralph report. According to that report, the rationale for the discount was to improve Australia’s international competitiveness

while promoting investment in innovative and high growth companies likely to produce significant capital gains (Ralph 1999, p. 14).

The calculated capital gain allows for relevant capital costs associated with acquiring and holding the asset. In addition, the CGT cost base is reduced to the extent that capital works deductions have been claimed for income tax purposes. (In contrast, depreciation claimed on fixtures and fittings is not deducted as these 'depreciating' assets are not subject to CGT.) However, where the taxpayer is eligible for a discount, only part of the capital works deductions previously claimed is subject to tax — the implications of this treatment are discussed in section 5.4.

The Government is considering the implications of including buildings and structures in the uniform capital allowance system applying since 1 July 2001. This would remove the capital works deductions provisions from CGT arrangements and thus end the current discounting effect. However, the Government has indicated that:

> This measure raises a number of extremely difficult practical issues, including separating land value from that of the buildings and structures, and defining the asset unit (a single building or many smaller assets). In light of the need for significant amounts of further work and competing tax priorities, the measure, if proceeded with, will not commence until at least July 2005. (Coonan 2002)

Goods and services tax

From 1 July 2000, GST has applied (at a rate of 10 per cent) on the supply of most goods and services in Australia. It is collected by the Australian Government, but its proceeds are distributed to the states and territories.

GST was introduced by agreement between the Australian Government and state and territory governments, as part of a package of tax reforms. This included the removal and rationalisation of a number of state and territory taxes. As a transitional measure, the Australian Government makes up any shortfall in state and territory revenue occurring as a result of these changes. These shortfall payments, totalling an estimated $370 million in 2003-04 (compared to GST revenue of some $32 billion), have reduced over time (Costello 2003). In that year, only NSW and Victoria are expected to receive shortfall payments, with NSW alone expected to receive payments in the following two financial years.

In relation to land and housing, GST is imposed on:

- *Vacant land* sold by registered enterprises. However, there are some exemptions; for example, sales of farm land and government land grants. As well, the

operation of the 'margin scheme' may act to restrict the GST payable on land sales to the increases in value since 1 July 2000.

- *New residential premises erected on vacant land*. 'New' is defined to encompass premises which have not previously been sold as residential premises, those created through substantial renovations, or those built to replace demolished premises on the same land. It excludes residential premises which have been rented out for five years.
- *Building materials and services* used in the construction of new housing or renovations (although wholesale sales tax which had applied to some of these items was removed when the GST was introduced). GST also applies to property management services, and selling and conveyancing expenses.

Official estimates for GST revenue raised from housing activity are not available. The Housing Industry Association (HIA) estimated that, based on industry activity levels, the GST lifted indirect tax receipts from new housing and renovations by more than $3.6 billion in the first year and in excess of $5 billion in 2002-03 (sub. 177, p. 52). The latter figure is made up of about $2.5 billion in respect of new housing, $2 billion in respect of renovations and about $0.5 billion each in respect of repairs and maintenance, and land development (sub. DR260, p. 10). GST collections of around $5 billion appear broadly consistent with the ABS estimate of gross fixed capital formation for private dwellings in 2002-03 of $48 billion.

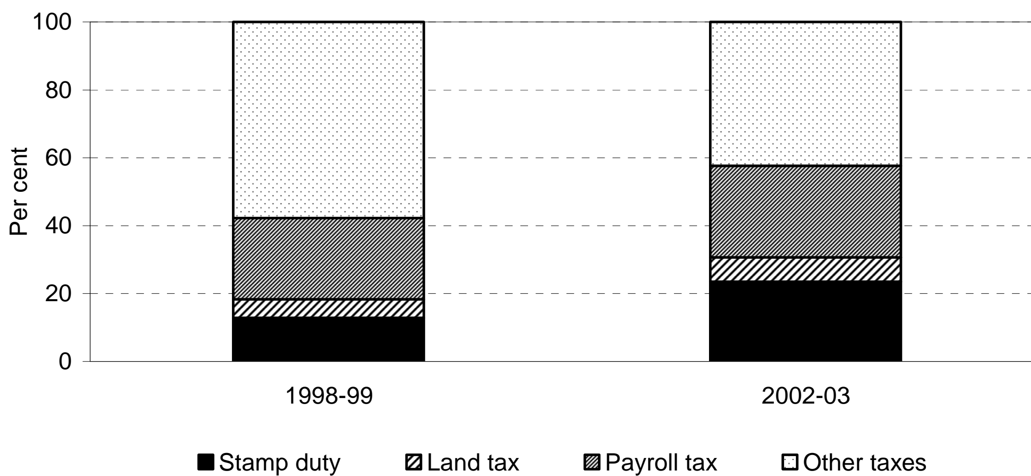
State and territory taxation arrangements

Recent tax changes, particularly the introduction of the GST, have led to a realignment of the revenue importance of the remaining state-level taxes and charges (see figure 5.1). The large increase in the importance of stamp duty receipts is also partly due to strong growth in house prices and higher turnover of the housing stock.

Stamp duty

State and territory stamp duties on sales of land and housing apply on top of GST, with marginal rates ranging up to about 7 per cent, but with significant variation in the rates across jurisdictions. Duty can be levied more than once as ownership changes from original land owner, to developer, to builder and to the final purchaser.

Figure 5.1 **Composition of state and territory taxation revenue**



Note. Data, which exclude GST, are for all jurisdictions combined. Although stamp duty includes duty on commercial conveyances, the vast majority is collected on conveyances of residential properties.

Data sources: ABS (*Taxation Revenue*, Cat. no. 5506.0) and State Budget Papers.

In all capital cities, the amount of stamp duty payable on a median valued home has increased significantly in the past five years (see table 5.1), mainly because of the increase in prices coupled with the progressive structure of stamp duty rates. (That is, the percentage tax paid increases with the house price.) However, increases in scheduled rates in WA, SA and the ACT have also contributed.

As a result, and because of increases in housing turnover (chapter 2), total stamp duty revenue has risen strongly (see figure 5.2).

Every state and territory provides stamp duty concessions for first home buyers, though in the ACT these concessions are available to all home buyers, subject to an income test. Concessions generally take the form of reduced amounts of duty (sometimes to zero), while in Tasmania first home buyers are allowed to stagger stamp duty payments over a two-year period. However, as these concessions are generally restricted to homes below specified threshold values, many first home buyers miss out. For example, for sales transacted in January 2004, in Victoria, Queensland, SA and Tasmania a first home buyer purchasing a home of 'average' price would not have received any concession, relative to other owner occupiers (see table 5.2).

In contrast to other jurisdictions, Queensland and the NT provide separate stamp duty concessions for all owner occupiers, though the level of concession is less than that for first home buyers.

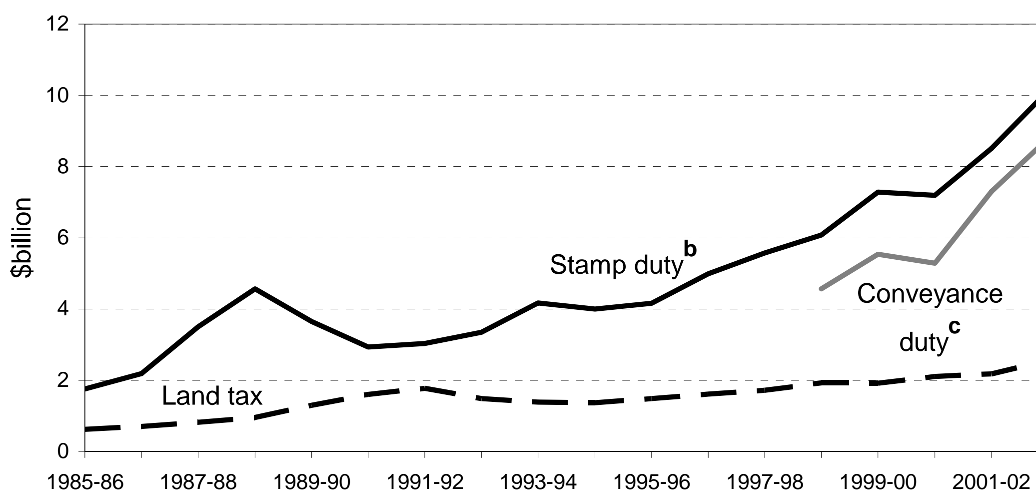
Table 5.1 **Stamp duty payable on the median valued home by non-concessional home buyers**

	1998		2003			
	Median value	*Stamp duty liability*	*Median value*	*Stamp duty liability*	*Change in median house price*	*Change in stamp duty*
	$'000	$	$'000	$	per cent	per cent
Sydney	249	7 205	442	15 380	78	113
Melbourne	155	4 960	272	11 980	75	142
Brisbane[a]	144	1 440	290	3 900	101	171
Perth	143	3 721	211	7 803	48	110
Adelaide	119	3 590	225	7 893	89	120
Hobart	107	2 635	181	5 010	69	90
Darwin[a]	174	4 122	211	5 825	21	41
Canberra	156	3 975	294	9 260	88	133

[a] The figures for Brisbane and Darwin apply to the principal place of residence only, with higher rates applying to rental housing. Also, as discussed in the text, all jurisdictions provide concessions to first home buyers — see table 5.2.

Sources: Productivity Commission estimates based on Australian Government Treasury (unpublished), Valuer-General departments, REIA (unpublished) and ABS (unpublished), stamp duty rates from NSW Treasury (2003).

Figure 5.2 **Trends in stamp duty and land tax revenue to 2002-03**[a]



[a] Current dollars. All jurisdictions combined. [b] Stamp duty includes duties on conveyances, leases, rental arrangements, loans, marketable securities and life insurance premiums. [c] Although conveyance duty includes duty on commercial conveyances, the vast majority is collected on conveyances of residential properties.

Data source: ABS (*Taxation Revenue*, Cat. no. 5506.0).

Most jurisdictions adjust their concessional thresholds periodically as house prices increase. For instance, the WA Government recently increased its first home buyer concession limit from $202 500 to $277 500. And the Queensland Government has

announced that the State's concessions will be broadened from 1 May 2004, subject to approval by Parliament. From that date, Queensland's first home buyers will pay lower stamp duty on houses valued at up to $500 000, rather than the $160 000 limit that currently applies.

Table 5.2 **Stamp duty payable by first home buyers — January 2004**

	Cut-off for first home buyers concession [a]	*'Average' first home buyer price* [b]	*Stamp duty payable by first home buyers*	*Stamp duty payable by owner occupiers*
	$'000	$'000	$	$
NSW	300	261	5 484	7 625
Vic [c]	200	215	8 560	8 560
Qld	160	195	1 950	1 950[d]
WA	278	172	5 450	5 950
SA	130	158	5 150	5 150
Tas	120	144	3 745	3 745
NT	no limit	161	1 425	3 566[d]
ACT	249	231	5 513[e]	5 513[e]

[a] First home buyers do not receive stamp duty concessions on houses that are valued above these prices. [b] Based on the average home loan taken out by a first home buyer assuming a loan to valuation ratio of 90 per cent. [c] To qualify for the first home buyer concession in Victoria, the buyer must be a pensioner or have at least one child under the age of 18. [d] Stamp duty payable on a principal residence. Higher rates apply for investment houses. [e] Higher duty applies to buyers who fail the income test.

Sources: Productivity Commission estimates based on Australian Government Treasury (unpublished), Valuer-General departments, REIA (unpublished), ABS *Housing Finance for Owner Occupation* (Cat. no. 5609.0) and ABS (unpublished), stamp duty rates from NSW Treasury (2003).

Land tax

All states and territories, other than the NT, impose taxes on the unimproved value of commercial land holdings, including land for rental housing, on an annual or more frequent basis. Owner-occupied housing is not generally subject to land tax, with the exception being principal residences valued at more than $1.97 million in NSW.

Like stamp duties, land tax rates are progressive, with marginal rates varying up to about 5 per cent. Often, separate land holdings under common ownership are aggregated for the purposes of calculating land tax liabilities.

Land tax revenue has grown in recent years — although by much less than stamp duties (see figure 5.2) — as the value of land has increased. Growth over the past five years has been moderated somewhat by increases in the rate thresholds in most jurisdictions and also by reductions in tax rates in NSW, WA and Tasmania. In the other jurisdictions, rates have not changed over this period, up or down.

Other taxes

A number of other taxes imposed by state and territory governments affect land and housing. These include: levies on residential property to fund emergency services; duty on the amounts secured on mortgages and loans (except in the ACT, the NT and, from 1 July 2004, in Victoria); duties on commercial leases (except in Victoria and Tasmania); a change-of-use (or betterment) charge in the ACT, aiming to appropriate 75 per cent of the estimated 'value added' due to re-zoning (though this raised only $3.9 million in 2002-03); and metropolitan improvement levies on households and land in Victoria and WA. (These levies are separate from developer charges, dealt with in chapter 7.)

Collectively, these taxes account for about 5 per cent of state taxation revenue (excluding the GST).

5.2 Housing taxation arrangements in other countries

Although international comparisons of taxation arrangements can be difficult, Australia's reliance on specific property taxation seems high compared with many other countries. Such taxation accounted for about 9 per cent of total taxation revenue for Australia in 2001, compared with a range from below 2 per cent to 12 per cent in a selection of overseas countries (see figure 5.3).

Australia's specific property taxation relies almost equally on taxes on immovable property (such as rates and land taxes) and on financial and capital transactions (such as stamp and mortgage duties), but there is wide variation in this respect among countries. Some countries, such as the United Kingdom, the United States, Canada and New Zealand, make relatively little use of specific transactions taxes on property although many, including the United Kingdom, do levy stamp duties.

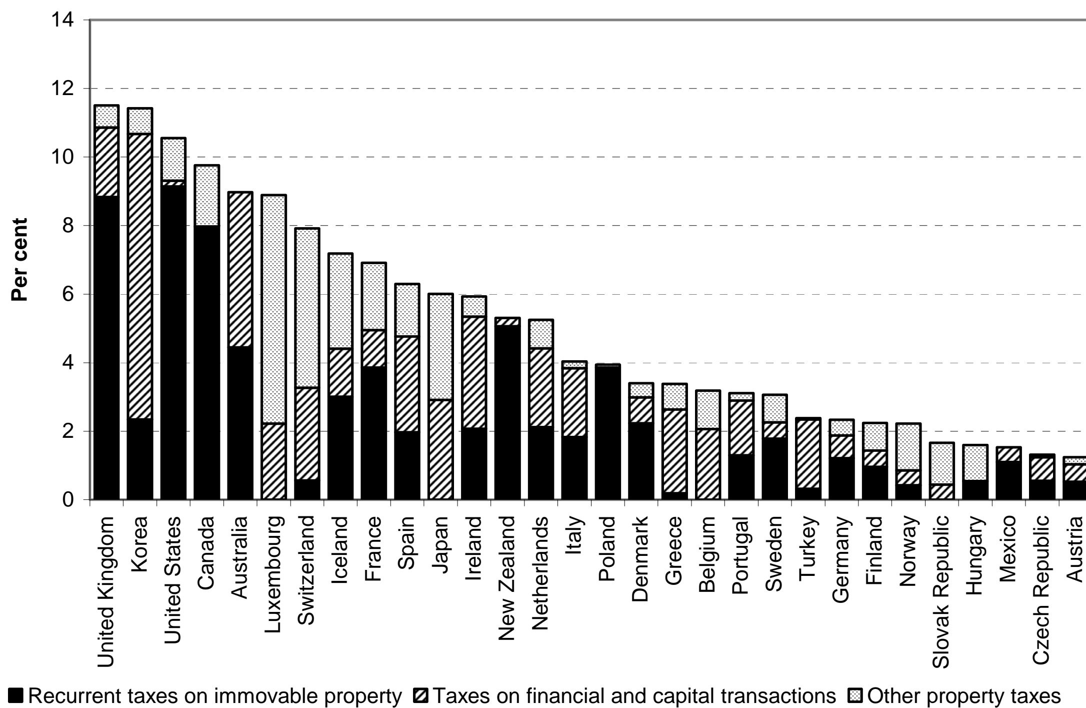
Importantly, however, the data in figure 5.3 exclude revenue collected from property by broader taxes such as value added and capital gains taxes. Hence, they provide only a partial perspective of the importance of property to each country's tax base.

The taxation treatment of owner-occupied housing in Australia is similar to that in countries such as the United Kingdom, New Zealand, Canada, France and Germany (see table 5.3).

In the past, taxation of imputed rental income on the 'family' home was more widespread. But a range of issues, including administrative and compliance problems, has led to a decline in the use of this tax instrument. Where such taxation

does remain, imputed rental income is generally low compared with market rates — for example, in the Netherlands it is set at 0.8 per cent of the value of the home (IBFD 2003, p. 447) — and collection remains administratively complicated.

Figure 5.3 **Property taxation as a share of total taxation revenue, 2001**



Note. Other property taxes include recurrent taxes on net wealth, estate, inheritance and gift taxes.

Data sources: OECD (2002a, 2003).

Interest deductibility for owner-occupied housing was similarly more widespread in the past, but concerns about its potential to inflate housing demand have led to its removal in countries such as the United Kingdom and France.

A simple comparison of tax measures applying to investment in rental housing across a range of countries suggests that Australia's provisions are relatively favourable (see table 5.3). Indeed, several participants were of this view (see below).

However, tax regimes are complex and a tabular comparison such as this cannot pick up the impacts of inter-country differences in important variables such as tax rates and deductibility provisions. Further, tax effects can vary across individual investments over time and between countries depending on market conditions. 'Generous' negative gearing provisions, for example, are of more value when income tax rates and interest rates are high. Another relevant factor, not encompassed in the table, is how taxation arrangements for investment in rental

housing in each country compare with the taxation regimes for other classes of assets, such as equities. Australia's tax treatment of investment in rental housing, and its implications, are discussed in section 5.4 below.

Table 5.3 **Tax treatment of owner-occupied and investment housing across countries**

	Owner-occupied housing			*Investment housing*			
	Imputed rent taxation	*Interest deductibility*	*Capital gains tax*	*Negative gearing*	*Depreciation allowances*	*Capital gains tax*[a]	*Stamp duty*
Australia	No	No	No	Yes	Yes	Discount	Yes
Canada	No	No	No	Restricted	Yes	Discount	Yes[b]
France	No	No	No	Restricted	Yes	Discount	Yes
Germany	No	No	No (after 2 years)	Restricted	Yes	Discount	Yes
Japan	No	No	Yes	Yes	Yes	Discount	Yes
Netherlands	Yes	Yes	No	No	No	Discount	Yes
New Zealand	No	No	No	Yes	Yes	No[c]	No
Sweden	Yes (through property tax)	Yes	Yes	Restricted	Yes	Yes	Yes
United Kingdom	No	No	No	No	No	Yes	Yes
United States	No	Yes	No (after 2 years)	Restricted	Yes	Yes	No

[a] 'Discount' means less than 100 per cent of the capital gain is taxed. [b] In approximately half of all provinces. [c] Except for depreciation claw back.

Sources: OECD (2001); RBA (sub. 199); French Ministry of Finance and Industry (2003); Japanese Ministry of Finance (2003); New Zealand Inland Revenue (2003); Dutch Revenue Office (2001); Swedish National Tax Board (2002); United Kingdom Inland Revenue (2003a, 2003b); German Tax Data (2001); Barker (2003); CCH (2002).

5.3 What are the price effects of these taxes?

Statutory application versus final incidence

When examining the effect of taxation arrangements on house prices (and housing affordability), the statutory application of a tax may not be a guide to its final incidence. (This section discusses how *taxes* on housing are shared between buyers and sellers — as discussed in chapter 7, the incidence of *charges* on housing for infrastructure services is quite different.)

Some taxes are initially imposed on suppliers of land and housing — examples include stamp duties paid when property changes ownership prior to final sale. Other taxes, such as the GST on new houses, are effectively incorporated into the market price paid by the buyer and then remitted by the seller to government. In the case of stamp duties on final sale, tax is not included in the market price paid to the seller, but is separately paid to the government by the buyer.

The ultimate effect on house prices depends, however, on how these taxes are 'shared' between buyers and sellers as a result of the interaction of demand and supply in the market. While the views of participants on this differed (see box 5.1), in broad terms, the final incidence will depend on: the relative responsiveness of supply and demand to price in the housing market generally and its various submarkets; the time horizon; whether a new tax, or a change to an existing tax, was anticipated; and whether the tax in question is specific to housing or applies more generally. These points are dealt with in turn below.

The basic proposition that the final incidence of a housing-specific tax imposed on either buyers or sellers depends on the responsiveness of housing supply and demand to price changes, is illustrated by the example in box 5.2. What follows is that factors influencing the 'elasticity' of demand and supply will be integral in determining how such taxes on housing are shared between buyers and sellers.

The 'response time' is critical

In the short term, the supply of land for housing is essentially fixed. There are also other constraints and delays in bringing new dwellings to the market and in upgrading the existing housing stock (chapters 6 to 8). This implies that demand surges are likely to have a quite limited effect on housing supply in the short term even if prices rise significantly (that is, supply is relatively 'inelastic'). For example, the WA Government observed that:

> … the typical lead time for the planning and development of new land and housing in the Perth metropolitan region is three to five years. There is little practical scope to have sub-divided land supply 'on call' and ready for sale (i.e. with infrastructure installed) to meet sudden surges in demand … (sub. 190, p. 28)

In contrast, demand for housing will vary somewhat as prices change, even in the short term. In this situation, an increase in specific taxes on housing such as stamp duty will tend to reduce the quantity demanded, but sellers will be willing to accept some reduction in the price they receive in the short term to maintain sales levels. Similarly, if taxes are reduced, demand will tend to increase but, because supply is largely fixed in the short term, sellers can ask for higher after-tax prices. In both cases, most of the immediate price effects of tax changes will fall on the seller of

property (as a benefit or cost), with the price (inclusive of tax) paid by a buyer being little affected.

Box 5.1 **Who bears the burden of housing taxes?**

Participants differed in their views about how the burden of taxes on land and housing, and the benefits of any reductions in those taxes, are distributed between buyers and sellers of property.

Most passed back to sellers?

Professor Peter Abelson

> … in most cases, and for most practical purposes including policy making, taxes [on housing] reduce undeveloped land prices rather than increase house prices. (sub. 21, p. 1)

ANZ

> A fall in stamp duties is likely to lead to a corresponding rise in house prices. House buyers would be little better off, and house sellers would obtain a windfall gain at the expense of state governments. (sub. 193, p. 12)

SA Government

> … there is no guarantee that the stamp duty relief would be passed on to purchasers of 'house and land' packages and not reflected in a higher developer's margin. (sub. 98, p. 53)

Most passed forward to buyers?

Terry Dwyer

> It is sometimes suggested that transfer taxes such as GST or stamp duty can be passed backwards to land developers and therefore are borne by the landholders whose land is purchased for development. This is a profound mistake in analysis. (sub. 144, p. 3)

Housing Industry Association

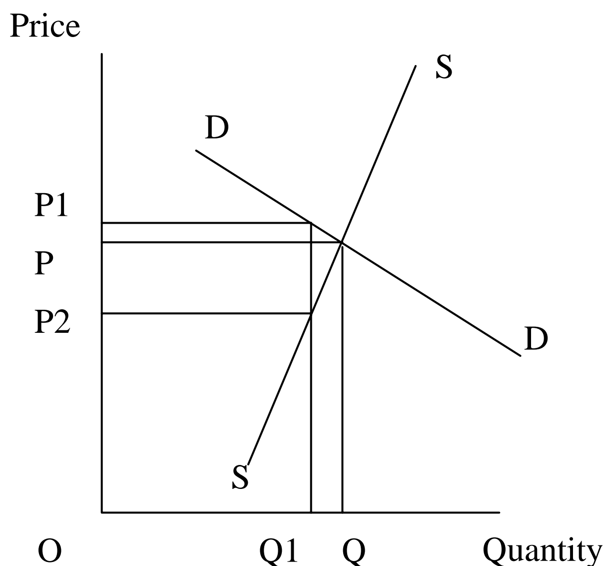
> In relation to property taxes and levies … the developer is usually able to incorporate this charge in the final price of their land and home package. In this sense, the economic incidence … is 'passed forward' to the new home owner. (sub. 177, Access Economics report, p. 35)

In the medium to long term, however, there is considerable scope to increase the supply of dwellings — through, for example, development of new housing land, moves to smaller block sizes, infill development and higher density living — as well as to upgrade the quality of the existing stock. In addition, people can relocate to areas where house prices are lower. Over time a higher proportion of the cost (or benefit) of a change to a specific housing tax will therefore be borne by (or accrue to) the buyer.

Box 5.2 **Who pays a housing-specific tax: the theory**

'Real world' outcomes are complex and dynamic, as the HIA noted in response to the Discussion Draft (sub. DR260, p. 15). Hence, the net effects of taxation arrangements affecting housing, especially broadly-based taxes, could only be quantified through detailed modelling. Nonetheless, the proposition that housing-specific taxes will usually be shared between buyers and sellers is a robust one, though the degree of sharing depends on several factors (see text).

The following partial and static analysis does *not* purport to represent the incidence of any actual tax on housing. It merely serves to illustrate the mechanism by which a housing-specific tax — such as stamp duty — will be shared between the buyer and seller. In the diagram, SS represents the supply curve, and DD the demand curve for housing services in the absence of tax, with OP the selling price. Suppose a tax of OP1 – OP2 is initially imposed on the buyer. The quantity of housing services demanded will decline — this reduces the price rise faced by buyers and effectively passes on some of the tax to sellers. Alternatively, the same tax initially imposed on sellers will reduce the selling price (provided that supply is not totally insensitive to price), leading to a reduction in the quantity of housing services supplied and, in turn, effectively increasing the price paid by buyers.



For most of a tax to be passed on to buyers, as implied by the HIA and some other participants, supply would need to be highly elastic (ie the supply curve in the diagram would be close to horizontal), a notion at odds with the usual view of land and housing markets (see text). Conversely, if supply is 'inelastic' (that is, the supply curve in the diagram is close to vertical), and demand is more elastic (as in the diagram), the quantity response to the imposition of a tax will be small, the share of the tax borne by buyers will be low and the share borne by sellers will be high.

However, as the relevant time period lengthens, both demand and supply will tend to become more elastic and hence the cost of the tax will be shared more evenly by buyers and sellers. Moreover, the incidence of a broadly-based tax such as the GST will differ from a housing-specific tax to which the preceding analysis refers (see text).

Moreover, over time, any tax impost on ‘middle men’ — for example, land developers — is also likely to diminish. In the short term, it is possible that developers will bear some of the cost of an increase in a housing tax. That is, if they have purchased land prior to an unanticipated tax increase, then in terms of the analysis in box 5.2, they will effectively become the seller and incur a ‘windfall’ loss. However, over the longer term, higher taxes will see developers paying less for raw land than otherwise, demand conditions being equal, meaning that the tax burden will again be shared between house purchasers and the owners of undeveloped land.

Broadly-based versus housing-specific taxes

Broadly-based taxes will have different incidence effects. As noted above, some of the taxes that apply to housing also apply to other assets, and the GST applies to most goods and services.

The effects of a broadly-based tax will generally be more complicated, both in terms of their initial incidence and their subsequent flow-through, than those of a tax specific to one area of activity, such as housing. Thus, empirical modelling would be required to explore those effects in any detail. As discussed below, such modelling has been employed to analyse the impacts of the GST on house prices.

That said, the partial equilibrium analysis of a housing-specific tax in box 5.2 is still relevant in considering what would happen were the GST to be removed on housing alone. The initial cost reduction from such a housing-specific change would be shared between buyers and sellers, as described in the box, meaning that the cost of buying a home would fall by less than the amount of tax removed.

The preceding discussion also indicates the need to distinguish between tax-inclusive and tax-exclusive prices — including in an affordability context. A tax reduction on housing, for example, will eventually lead to an increase in the volume of houses bought and sold, with both buyers and sellers benefiting from the ensuing price change — buyers will pay a lower *tax-inclusive* price, while sellers will receive a higher *tax-exclusive* price than before.

Price effects of recent tax changes

The Commission has not attempted any special economic modelling of the effects of taxation arrangements affecting housing, or of recent changes to these arrangements. In the time available, it has been necessary to focus effort on the central issue of housing affordability, rather than divert attention to detailed tax modelling which is inherently difficult and resource intensive.

Goods and services tax

Several participants commented on the effects on house prices of the imposition of the GST. The Victorian Government, for example, considered that the GST has increased the price of purchasing a *new* home 'by around 6 to 8 per cent, although the exact figure is undeterminable' (sub. 85, p. 37). The Master Builders Association noted that the Australian Competition and Consumer Commission, in its *Price Guide* released in May 2000, estimated the price change for a *new* house (excluding land) as being between 7.8 per cent and 9 per cent (sub. 135, p. 16).

These estimates are compatible with projections made by Econtech (2000) immediately prior to the introduction of the GST. It projected an initial price effect on *new* housing of 9 per cent, after taking account of the effects of the removal of wholesale sales tax and other impositions. But in the long term, allowing for the spur to business investment from replacing those previous taxes with the GST, the projected price rise was 7.1 per cent.

The Commission was advised by Treasury that its estimate of the impact of the introduction of the GST, and the removal of wholesale sales tax and other indirect taxes, on the price of construction was lower at 5.5 per cent. This figure relates to the amount by which prices in the industry would need to rise to recover the GST impost, taking account of the reductions in costs flowing from the abolition of other taxes, and assuming that profit margins in the industry remained unchanged.

However, GST does not apply to housing stock which has been previously sold. Thus, whatever its price raising effect on new dwellings sold, its impact on overall housing price levels is likely to be somewhat smaller, especially in the short term. Of course, in time, there will be greater 'pass through', especially as the proportion of the stock that has been subject to GST on initial sale increases. Hence, its price effect across the whole housing stock will be commensurately higher. The HIA argued that this pass through effect has in fact been quite rapid, with the GST effectively becoming 'capitalised' into the price of existing housing through 2001-02 (sub. DR260, p. 10). But as discussed further in this and other chapters, the introduction of the GST has been only one of many demand and supply factors influencing house price growth in the last few years.

Capital gains tax

Many participants considered that the changes made to CGT arrangements in 1999 provided significant impetus to subsequent increases in house prices. Indeed, as discussed further in the following section, these changes have almost certainly contributed to the surge in investment in rental housing in the past few years.

In general, provided nominal house prices increase by more than twice the rate of inflation over the relevant ownership period, the new arrangements advantage the investor. This situation has prevailed over much, if not all, of the post-1999 period. Of course, this generalisation abstracts from the effect of capital works deductions and also the effect on house prices themselves of the changes in CGT provisions. Nevertheless, it is clear that, in the context of recent strong house price growth, the CGT change has given impetus to investment in rental housing and added to price pressures.

But there is no guarantee that recent rates of price increase will be maintained in future. Indeed, there is a general expectation that, at the very least, price growth will slow (chapter 9). If this happens, or were inflation rates to increase, less capital gains tax might be payable by future home buyers, if the pre-1999 arrangement had been continued.

Stamp duties and land taxes

As noted, there have been some minor changes (up and down) in the *scheduled* rates of stamp duties and land taxes in recent years. As well, some exemptions and concessions have been altered.

The wide range of scheduled rates that apply both within and between jurisdictions, together with extensive exemptions and concessions, make any analytical assessment of the aggregate price effects of changes to those arrangements virtually impossible. As recent changes have been small, however, any price effects arising directly from changes to *scheduled* rates will almost certainly have been minimal. This is not to downplay the point that, in total, stamp duties (in particular) raise significant revenue and that revenue collected has increased substantially as housing turnover and prices have increased. But as discussed above, the burden of increases in stamp duty rates, or less generous concessions, will be shared between buyers and sellers. Hence, the impacts on house prices will not have been as great as the increase in revenue collected would suggest.

Effects of income taxation arrangements applying to investment in rental housing

Many of the income tax arrangements affecting investment in rental housing also apply to investment in other assets, although their specific application and impact can vary across asset classes. These arrangements include CGT, negative gearing, capital works deductions and depreciation provisions.

Like many participants (see box 5.3), the Commission has concluded that these general taxation arrangements have lent impetus to the recent surge in investment in rental housing and consequent house price increases. In essence, they have reinforced the incentives for such investment resulting from falling real interest rates, easier availability of finance and lower returns in equities markets.

Box 5.3 **Participants' comments on the tax treatment of rental housing**

Reserve Bank of Australia

> 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 … :
>
> – 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. (sub. 199, pp. 37–8)

Victorian Government

> In the context of a period of relatively low inflation, but strong growth in house prices, these [CGT] changes encouraged greater investor activity in the housing market, adding further demand pressure to the market. (sub. 85, p. 37)

NSW Government

> … the relatively favourable taxation of residential property income and capital gains may encourage over-investment in residential property. (sub. 187, p. 59)

Australian Council of Social Service

> Negative gearing arrangements, together with the hasty decision to cut CGT rates on personal incomes by half from 2000, have added fuel to the present investment property boom. (sub. 147, p. 17)

Australian Consumers' Association

> In a period of low inflation … [the revised CGT regime] … has given a large incentive to investors seeking (or expecting) opportunities for capital gains. (sub. 122, p. 16)

NSW Council of Social Services

> … we all know that negative gearing is a rort, frankly. We wouldn't find it so objectionable if it were at least used for some useful social benefit … (trans., p. 238)

CPA Australia

> The favourable tax treatment for investors in Australia relates mainly to the treatment of negative gearing, capital gains tax, and depreciation particularly in the context of high marginal income tax rates. (sub. DR319, attachment p. 10)

Some of these taxation arrangements, such as negative gearing and expense deductibility, have been of long standing. But their potential benefits have increased

as rising incomes have pushed more investors into higher tax brackets. For example, the proportion of taxpayers reporting taxable income in the highest tax bracket rose from 9 per cent in 1994-95 to 12 per cent in 2000-01 (ATO 2003).

Given the low rental yields currently available from much housing investment (chapter 2), investors must be expecting most of their return to come from future capital gains. Here, too, the taxation regime has played a role. Were recent price trends to continue, the new CGT arrangements would result in higher after-tax capital gains than the previous arrangements. From this viewpoint, that change is likely to have acted to spur investor housing demand.

Collectively, therefore, the general income tax regime has facilitated highly geared housing investment aimed at reducing current taxable income and deferring tax until capital gains are realised in future years.

However, just as they have added impetus to the recent boom, so too could these arrangements reinforce any future market downturn. For example, as noted above, if house price growth slows or reverses, the revised CGT arrangements may turn out to be less beneficial for many future investors than the pre-1999 regime. This is just one reason why it is inadvisable to examine taxation arrangements affecting housing solely in the context of the recent price boom or, indeed, only in the context of housing. As discussed below, a broader perspective is needed.

5.4 Improving taxation arrangements affecting housing

Many participants requested or suggested changes to one or more of the taxation arrangements affecting housing. Some of the requests were intended to assist the housing sector generally, or groups such as first home buyers specifically — relevant issues are covered in chapter 10. Other requests were directed at overcoming perceived general deficiencies in present arrangements.

The policy challenge

Full assessment of tax arrangements and possible improvements must take account of a number of criteria, relating to efficiency, equity, predictability and transparency. Principles of good tax design, as summarised by a recent inquiry into business taxation in Victoria, are set out in box 5.4.

Even with the guidance of such criteria, however, making changes to existing taxation arrangements poses major challenges:

- All taxation arrangements require compromises in terms of assessment criteria. This point is illustrated by the diversity in international approaches to the taxation of land and housing (section 5.2).
- In Australia, the choice of tax measure and tax mix is constrained by the federal system of government. In particular, tax raising options for the states and territories are limited — stamp duties, payroll tax and land tax are important in this context.
- Moreover, many tax arrangements affecting housing markets apply more generally, so housing-driven changes to those arrangements would have implications for other areas of activity and investment.
- Similarly, introducing further housing-specific differentiation into tax arrangements might create new inter-sectoral distortions.

Box 5.4 **Principles of good tax design**

The Victorian Government's recent *Review of State Business Taxes* summarised principles of good tax design as follows:

> … a preferred tax would: raise the target amount of revenue with minimal impact on behaviour; treat taxpayers equally; be administratively simple to collect; impose low compliance costs on taxpayers, and provide no opportunities for tax avoidance; and ensure revenue stability.

It noted, however, that:

> In practice, no single tax is likely to score well on every criterion, and some tax design objectives may be mutually exclusive. For example, anti-avoidance measures can make administration complex, while progressive rate structures can achieve equity objectives but significantly distort decision making.

Source: Victoria 2001.

Consequently, the question becomes whether one imperfect set of tax arrangements is preferable to an imperfect alternative. And, even if there is agreement in principle that an alternative regime would be superior, there will often be substantial transitional issues which diminish the attractiveness of change.

The GST is a relatively 'good' tax

Compared with some of the other forms of tax affecting housing, such as stamp duties, the GST is, in general terms, a relatively efficient tax: being broadly-based and relatively uniform in application. Even though the GST applies specifically only to new houses and to alterations and additions, over time it is likely to be

increasingly capitalised into the prices of established housing and thereby passed on to all home buyers (see above).

Indeed, one of the main reasons for introducing the GST was to replace less efficient tax measures, including some affecting housing markets. As it transpired, several of those taxes were retained, though some are subject to review in 2005 (see below).

Notwithstanding its general advantages, some participants raised questions about the way the GST currently applies to housing. For example, the HIA was critical that exemptions on early stage transactions — payment of GST-exempt fees and charges by land developers to local councils for such things as building certificates, development applications and subdivision fees — do not carry through to transactions with the final purchasers (that is, home buyers). It estimated that annual revenue derived from the application of GST to GST-exempt state and local taxes was of the order of $500 million (trans., p. 93). Such an impost would amount to around 1 per cent of the annual value of new housing construction (including maintenance, renovations and additions). The HIA recommended that a notional or imputed input tax credit be allowed on such transactions, even though no GST had actually been paid — thus reducing the cost to the final purchaser and giving effect to 'the principle … that GST should not be levied on local and state government taxes' (sub. 177, p. 54).

In the Discussion Draft, the Commission commented that, although this aspect of the current GST regime may have particular effect in the housing area, it is a general tax design issue which is relevant to a range of activities. It also pointed out that dealing with the issue would raise administrative difficulties and have revenue implications. The HIA contended in response that the revenue collected represents a windfall to government rather than the result of deliberate tax design, and that the necessary administrative arrangements to rectify the situation could not be described as 'cumbersome and expensive':

> Claims for input tax credits (ITCs) would be made, as now, via the [Business Activity Statement] process, and all supporting documentation would, as now, be retained by the GST-Registered person. Calculation of the amount of the notional ITC is exactly the same as for the calculation of any other ITC on a receipt where GST is not explicitly stated — 1/11 of the purchase price. The main issue is whether any particular acquisition is a creditable acquisition, and the same tests as currently used would apply. (sub. DR260, p. 11)

Adoption of the HIA's suggestions could bring a small improvement in housing affordability. The Commission nevertheless stands by its assessment that the issue is one of general tax design relevant to a range of activities, and that the administrative and revenue implications of any revision to current arrangements

would need to be addressed. Indeed, given the relative efficiency of the GST, it is likely that replacing lost revenue of the order of $500 million annually through adjustment to other forms of tax would end up reducing community welfare.

Participants also raised issues about payment of GST on prices which already include other taxes, such as stamp duty. This is considered in the following section.

Stamp duties and land tax: scope for reform?

General shortcomings of stamp duties

The focus of much of the input from participants on stamp duties related to the impact on the affordability and accessibility of housing.

In terms of affordability, stamp duties can directly add 5 per cent or more to the purchase price. However, because of concessions, the direct impost on many first home buyers is much less than this. Further, as mentioned earlier, part of the cost of stamp duties is likely to be passed back to the seller, meaning that house prices are somewhat lower than they would be in the absence of duties.

But the effect on accessibility to home ownership can be greater. For example, for a home buyer required to provide 10 per cent of the purchase price as a deposit, a stamp duty of 5 per cent increases the deposit gap by 50 per cent. Meeting this extra upfront cost might require first home buyers to delay their entry to the market while saving the additional funds. Alternatively, it could require them to borrow more, possibly at a higher interest rate. Here again, of course, stamp duty concessions may reduce or eliminate that problem.

In addition to reducing affordability and accessibility, stamp duties also have broader efficiency costs. So-called ‘lock-in’ effects that arise because stamp duties apply only when a property is sold, have been a focus of attention. Intending first home buyers (unless exempt) have little choice but to pay any stamp duty applicable. But those already in their own home can avoid stamp duty by the simple expedient of staying put, even if a change of housing type or location might better suit their needs. To them, stamp duty looms as a large tax on buying and selling, or on moving, rather than as a small tax on the capital value of the home.

By way of illustration, a ‘change-over’ buyer in Melbourne of a house of median value in June 2003 would have paid some $15 000 in stamp duty, in addition to legal fees and other expenses associated with selling an existing property and moving to another. Faced with such costs, some households contemplating ‘trading-up’ might instead decide to extend their existing home. Similarly, some older

people may decide to stay in their existing homes rather than 'trade down' to something more suitable. In effect, while stamp duty will only be a small fraction of the price of the preferred replacement dwelling, it looms much larger relative to the perceived benefits to the household from moving. As the Australian Bankers' Association commented:

> For an owner occupier, Stamp Duty represents a significant tax on moving residence, and therefore is a barrier to more efficient utilisation of the existing housing stock. (sub. 164, p. 15)

Any such 'lock-in' effects, by increasing the cost of relocating, can keep people in unsuitable housing, and impede transformation and consolidation of cities.

The significance of such impacts was questioned by some participants. Some state governments, for example, argued that in practice they are small, pointing to increased housing turnover in recent years despite higher average stamp duty payments. However, this does not rule out the possibility that, if stamp duties had been lower, housing turnover may have increased even more.

There are few data from which to assess lock-in effects. The Commission notes that housing turnover in New Zealand did increase slightly in the years following removal of stamp duty in 1988 compared with the years before — though the data are not comprehensive and could be influenced by cyclical factors (data obtained from Quotable Value 2004). Freebairn (2002) estimated efficiency losses from lock-in effects of between $200 million and $600 million a year. However, these seem modest in the context of the total revenue raised by stamp duties.

But lock-in effects are not the only potential source of efficiency loss arising from stamp duties. In the broadest sense, they are a tax on housing. Hence, for example, though such duties may partly serve to offset the tax 'preference' for equity financed owner occupiers (see below), they may add to the relative tax disadvantage experienced by those households forced to borrow heavily to purchase a family home. As well, investments in other classes of asset are either not subject to stamp duties, or are dutiable at lower rates. And, while stamp duty concessions clearly help to improve affordability and accessibility for many first home buyers, variation in stamp duty rates according to the type of buyer or the value of the dwelling may also have some efficiency costs. The large benefit from removing stamp duties projected by Access Economics in a study for the Real Estate Institute of Australia (REIA) may partly reflect these broader efficiency considerations (sub. 124, p. 17).

In terms of equity criteria, notwithstanding progressive rate structures and the exemptions and concessions that aim to promote distributional objectives, current stamp duty regimes also have shortcomings. While the SA Government noted that there could be a 'correlation between property value and income capacity' (sub. 98,

p. 53), stamp duties often treat people in like circumstances differently, and do not differentiate well on the basis of ability to pay. In particular, tax scales relate to the purchase price rather than income or wealth. Similarly, stamp duty concessions (other than in the ACT) take no account of income or assets. Stamp duties also impose greater burdens on those families which, for work or other reasons, need to move frequently.

For these sorts of reasons, a number of previous studies, including reports commissioned by state governments, have concluded that stamp duties on housing do detract from community welfare in a material way. The 2001 Victorian Review of State Business Taxes, for example, concluded:

> The Committee believes that stamp duty on residential conveyancing is an impediment to economic development and that the abolition of duty would go a long way towards providing a more appropriate, simple and consistent taxation system. (Victoria 2001, p. 77)

Reducing reliance on stamp duties

In their original submissions — and in response to the Discussion Draft — many participants argued that, because of problems such as those outlined above, reliance on stamp duties by state and territory governments should be reduced (see box 5.5). Suggested alternatives included placing greater reliance on land taxes, payroll taxes or the GST. Box 5.6 gives some rough estimates of the rates which would need to apply to replace stamp duties.

In the Discussion Draft, the Commission expressed the view that removal of stamp duties, and their replacement by more efficient forms of taxation, should be a priority at the state and territory level. It recognised, however, that such a change would have significant short-term consequences for taxpayers, governments and the community generally. The Commission therefore suggested that the foreshadowed intergovernmental review, to be held by 2005, of business-related conveyances, be extended to consider the removal of stamp duties on residential property.

In responding to these suggestions, many participants commented on the advantages and disadvantages of alternative taxes. While some state governments recognised problems with stamp duties, they were generally of the view that the case for removal of stamp duties was weak, that such removal could not be considered a priority and that there were major problems with the suggested alternatives. The WA Government, for instance, stated:

> While the Commission's proposals may, at least in theory, improve the efficiency and equity of the tax system, there is simply no support in the community for increasing

reliance on these taxes [payroll tax and land tax] — particularly if this were to be achieved by removing existing exemptions. (sub. DR339, p. 2)

Issues relevant to reducing reliance on stamp duties are considered below.

Box 5.5 Participants' views on reducing reliance on stamp duties

Prosper Australia

> … transaction taxes in the housing supply chain, ... [should be replaced by] a broad-based system of land value taxation (i.e. a system with minimal exemptions and no threshold) in order to replace the lost revenue from transaction taxes, force speculators to put their land on the market, increase pressure on landlords to seek tenants, reduce local opposition to new housing developments, and relieve the anxieties of politicians concerning the funding of infrastructure required by new developments. (sub. 68, p. 19)

Terry Dwyer

> Governments need to: get rid of transfer taxes which add to the cost of housing; use holding taxes such as rates to encourage land to come onto the market to be put to its best and highest [valued] use; and use rating to expand the supply of serviced land by earmarking rates for infrastructure expansion and refurbishment. (sub. 144, p. 11)

Australian Council of Social Service

> Governments should review land tax and stamp duty, and consider the introduction of betterment taxes to improve the equity of State and Territory property taxes and to encourage efficient investment in affordable housing. (sub. 147, p. 33)

Real Estate Institute of Australia

> … the States ought to abolish the State Stamp Duties on all types of non-residential property and other business transactions as soon as GST payments to the States reach the level of the Guaranteed Minimum Amount. (sub. 124, p. 18)

Professor Frank Stilwell

> Stamp duty has become a fundamentally important source of State revenue and could not be reduced unless an alternative revenue source were found. That alternative could be land tax. Although less in the political spotlight, land taxation and its interaction with the housing market could hold an important key to resolving the housing affordability crisis. (sub. 212, p. 2)

Master Builders Australia

> Master Builders strongly supports the rationale for replacing existing stamp duties with revenue accruing to states from the GST. (sub. DR256, p. 6)

Housing Industry Association

> … negotiating a replacement of stamp duty will be an exercise fraught with political difficulty. (sub DR260, p. 13)

Box 5.6 **Alternatives to stamp duty**

In 2002-03, conveyancing duties raised approximately $8.8 billion for state and territory governments, with the major proportion from residential conveyances. The Commission estimates that to replace that revenue (and in the case of land taxes to also cover the revenue already raised from such taxes) :

- land taxes would need to be applied at a rate of approximately 1 per cent on 'unimproved land values' across the board, including on owner occupiers;
- revenue from payroll taxes would need to be almost doubled — much of this requirement could be met by reducing concessions rather than raising rates; or
- the GST would need to be increased by between 2 and 3 percentage points.

Obviously, a mix of such taxes could be used, with the rates for the replacement taxes varying between states and territories depending on the revenue raised through stamp duties. Rates of replacement taxes would be lower than those given above if based on more 'normal' levels of stamp duty revenue, rather than the unprecedented collections during the housing boom. Furthermore, these estimates do not allow for any feedback effects from such tax changes on economic decision-making.

Land taxes are more efficient

In contrast to stamp duties, comprehensive taxation of the unimproved value of land at a relatively low rate, annually or more frequently, is generally regarded as having important efficiency advantages (at least in principle). In particular, because the supply of unimproved land is inelastic, a broad land tax is unlikely to significantly distort land use or building and housing choices. Further, it is a holding tax, rather than a tax which applies only on transactions. Hence, a (comprehensive) land tax cannot be avoided and, if applied at a broadly uniform rate, should not have the lock-in or other efficiency costs of the current stamp duty regime. Depending on its provisions, a land tax regime could also deliver more equitable outcomes than stamp duties.

Notwithstanding these in-principle advantages, the REIA was concerned that wider application of land tax would 'provide a disincentive to already diminishing yields on residential investment property' (sub. DR279, p. 7). And, the Victorian Government contended that replacing stamp duties with expanded land tax or payroll tax regimes were 'not feasible options' as 'a tripling of land tax or a near doubling of payroll taxes would be needed' (sub. DR301, p. 3).

However, the substantial increases estimated by the Victorian Government are in large part a reflection of the uneven application of land (and payroll) taxes. Land tax regimes are characterised by extensive exemptions and concessions, progressive

rate structures, and provisions for aggregation of land holdings for tax purposes. Apart from affecting the revenue raised, these provisions are likely to have adverse equity implications — owner occupiers are generally exempt while rental investors, and thus renters, pay — as well as implications for how the aggregate stock of unimproved land is divided between uses and between users.

Broadening the land tax base by removing or reducing existing exemptions and concessions could therefore provide a means to fund reduced reliance on stamp duties, without the need to increase current tax rates. Indeed, even if stamp duties were removed entirely, the rate of comprehensive land tax required to deliver revenue neutrality (see box 5.6) would be significantly less than the rates that currently apply to investment housing.

As a revenue-neutral change within the housing sector, replacement of some element of stamp duties with land taxes should have little overall effect on housing prices in the short term. That is, the stimulus to demand from the removal of stamp duty would be offset by a reduction in demand resulting from the obligation of home owners to pay the ongoing land tax. Hence, at least under this particular reform scenario, the concerns expressed by the NSW Government that, by boosting demand, abolishing stamp duties would push up house prices would not arise (sub. DR315, p. 2). Moreover, there could in fact be some improvement in housing accessibility if stamp duties were reduced, as upfront purchase costs would correspondingly decline.

Of course, a range of implementation issues and difficulties would need to be assessed before moving to a comprehensive basis of land taxation. For example:

- There could be significant cash flow implications for asset rich but income poor home owners. This is especially so as a greater share of the revenue impost on housing would be borne by owner occupiers — they would be required, in effect, to fund not only the revenue shortfall arising from the reduction of stamp duties on owner-occupied housing, but also a share of the stamp duties currently paid by investors in rental housing. The NSW Government commented that an estimated average annual tax bill of $1800 for the average household in that state, in addition to existing local government rates, 'would place a relatively high burden on low income families' (sub. DR315, p. 5). And, while such concerns could potentially be accommodated by allowing low income families to defer payment until the house is sold, this would both complicate administration and reduce the benefits of change. (As Zhong Jianying (sub. DR263, p. 1) noted, such deferred land tax would take on some of the characteristics of a stamp duty.)
- Provisions would be required to avoid retrospective application of tax to previously exempt land holdings.

- Rules would also be required for aggregation of multiple land holdings (if progressive rate structures were retained) and to cover land holdings spanning state borders.
- The treatment of land held by developers as short-term trading stock would be a further matter requiring resolution.

Payroll taxes

There are differing views on the efficiency of payroll tax compared with other forms of taxation. However, it is commonly agreed that there would be efficiency gains from significantly reducing or eliminating many of the current payroll tax exemptions and concessions. Accordingly, funding a reduction in stamp duties by reducing these exemptions and concessions offers the prospect of efficiency gains.

Again, however, various implementation issues would need to be assessed before moving in this direction. These include administrative and compliance costs, and issues relating to cash flow for those businesses that currently fall below payroll tax thresholds.

GST

Given that the GST is a relatively efficient tax (as discussed above), there could be some advantage in using the existing GST mechanism to replace, or reduce reliance on, stamp duties. Indeed, the incremental administrative and compliance costs would most likely be small, particularly if a reduced reliance on stamp duties could be funded from growth in existing GST revenue. However, the NSW Government stated that 'GST revenue growth will not allow the States to abolish transfer duty' (sub. DR315, p. 4). Similarly, the Tasmanian Government commented that:

> … incremental growth is unlikely, and was never intended, to compensate the States for further erosion of their own sources of revenue in the form of the abolition of additional State taxes. (sub. DR320, p. 11)

Moreover, as with greater reliance on land taxes and payroll taxes, an increase in the GST rate (or an expansion of GST coverage) would raise numerous implementation issues, including the distributional consequences for low income families.

A priority for change?

As noted above, several state governments argued that removal of stamp duties could not be considered a priority for tax reform. For example, the SA Government

responded that ‘it is unclear that stamp duty on residential property would be the highest priority state tax for abolition’ (sub. DR295, p. 2). Similarly the NSW Government stated that ‘the Commission does not demonstrate that abolishing transfer duty should be a priority for taxation reform’ (sub. DR315, p. 3).

The Commission acknowledges that some other state taxes may well require more urgent attention than stamp duties. Nevertheless, in view of the potential accessibility and efficiency benefits, it considers that initiatives to reduce reliance on stamp duties are warranted. The Commission notes that the recent Victorian Government Review of State Business taxes reached the same conclusion (Victoria 2001, p. 78).

The way ahead

In responding to the Discussion Draft, some state governments contended that the composition of any state’s tax regime is a matter for individual state governments to determine.

Individual state and territory governments have the authority and ability to change their own taxation arrangements, should they so wish. In the Commission’s view, any move by individual jurisdictions away from stamp duties towards more efficient taxes would be welcome.

However, the Commission considers that the nature of some of the issues involved means that cooperation between the Australian and the state and territory governments would most likely be required to facilitate change in this area. For example, any change to GST arrangements to help fund a reduction in stamp duties would require inter-jurisdictional discussion and negotiation. The WA Government also observed:

> Because of the States’ limited tax bases, declining share of national revenues and, particularly in Western Australia’s case, the effects of the Commonwealth Grants Commission (CGC) process, any reduced reliance on property taxes would need to take place in the context of reform to Commonwealth–State financial relations. (sub. 190, p. 44)

As several participants noted, the 1999 Intergovernmental Agreement on the reform of Commonwealth–State financial relations (the IGA) includes provision for stamp duties on business-related conveyances to be reviewed by 2005. In the Commission’s view, this would also be an appropriate forum in which to consider the priority that should be attached to the reform of stamp duties on property conveyances and the best means for doing so.

RECOMMENDATION 5.1

The coverage of the review to be held by 2005 under the 1999 Intergovernmental Agreement on the reform of Commonwealth–State financial relations, should be extended to include consideration of how best to reduce stamp duties on property conveyancing. In particular, the review should examine the scope to replace stamp duty revenue with more efficient forms of taxation or sources of revenue.

Indexing stamp duty rates

As noted, revenues from stamp duties have increased considerably as house prices have increased. The HIA and the REIA, among other participants, described at least some of the increase as a 'windfall' and called for stamp duty thresholds to be indexed or rates reduced as prices increase. Certainly, because of the progressive rate structure, stamp duty collections have risen by more than house prices.

However, such proposals were opposed by state governments. For example, the SA Government commented:

> Cyclical gains by their nature are transitory; they follow extended periods of stable or declining prices and will inevitably be followed by a period of subdued price movement if not price falls. (sub. 98, p. 44)

Indeed, stamp duty revenues have fallen in some years (see figure 5.2).

Indexation of rates — by stabilising revenue streams somewhat — might result in slightly less volatility in tax-inclusive house prices. Further, consistent with the previous discussion, appropriate indexation could bring some advantage in reducing the reliance of state governments on stamp duty revenue.

However, formal indexation of rates aimed at stabilising revenue would introduce a new set of problems. In particular, implementation could be difficult, requiring formulas based on past trends, or estimation or 'guesswork' about future price trends. Poor indexation could destabilise, rather than stabilise, markets. In this regard, the NSW Government noted that '… changes to rates and thresholds undertaken in one housing market environment may be completely inappropriate for the market environment a following year' (sub. 187, p. 49).

Given these problems, attempting to develop formulaic methods of indexation could divert attention from the advantages of reducing reliance on stamp duties in favour of more efficient forms of taxation. In any event, it always remains open to governments to adjust stamp duty rates from time to time on an ad hoc basis according to their revenue requirements.

Taxes on taxes, multiple taxation and aggregation

Stamp duties can apply to sales already subject to GST. And because stamp duty can be collected on more than one occasion as a property passes from seller to buyer, GST can also sometimes apply to stamp duty-inclusive sales amounts.

The HIA proposed that there should be:

> … a provision for land developers and builders to claim exemption from stamp duty on trading stock, similar to the operation of stamp duty for motor vehicle traders. (sub. 177, p. xi)

It also argued that '… the requirement to aggregate multiple land contracts for the purpose of assessing stamp duty' should be removed (sub. 177, p. xi). Because of the progressive stamp duty rate scales, such aggregation results in higher tax payments than if the subdivided blocks were taxed separately.

There could, in principle, be some efficiency gains from addressing these features of current tax arrangements. But, as the Commission noted in the Discussion Draft, a range of administrative and compliance complexities would at least partially offset these gains.

In response, the HIA contended that these '… administrative and compliance complexities are grossly overstated' (sub. DR260, p. 11). It also considered that:

> … the Commission should not be deflected from making a recommendation … if it considers that existing arrangements fail the 'Principles of Good Tax Design' tests or are otherwise inequitable or unjustified contributors to lack of housing affordability. (sub. DR260, p. 10)

Notwithstanding the HIA's view that the administrative requirements to effect change in this area are relatively straightforward, the Commission remains of the view that those requirements are still relevant in judging whether reform is worthwhile. For example, were quick action to remove or substantially reduce reliance on stamp duties a real possibility, devoting bureaucratic effort to the sort of changes proposed by the HIA would not seem sensible.

However, if the current reliance on stamp duties is likely to continue for the foreseeable future, there is a stronger case for addressing 'anomalies' of the sort identified by the HIA — taking into account administrative and compliance cost issues, and the efficiency and equity consequences of making up the shortfall in revenue.

RECOMMENDATION 5.2

If the 2005 intergovernmental review (or another mechanism) does not lead to reduced stamp duties on property transactions, a further forum should assess the potential gains from addressing property-related 'tax on tax' and 'multiple tax collection' issues.

Taxation of owner-occupied housing

As described earlier, there are a number of differences between the tax treatment of owner-occupied and investment housing. Unlike rent received from the ownership of housing purchased for investment purposes, the implicit rental benefits derived from owning one's own home (that is, imputed housing rent) are not taxed. Further, in contrast to investors in rental housing, owner occupiers are not subject to capital gains tax nor, except for those living in very high value properties in NSW, subject to state land tax. By the same token, tax deductions for housing expenses are not available to owner occupiers.

Whether imputed rental income should in principle be subject to tax has been the subject of long standing theoretical and policy debate. This is a very complex issue — especially when, as in Australia, the tax regime encompasses a mix of measures that variously tax income, consumption and asset holdings. For much the same reason, the theoretical basis for capital gains tax has also been much debated.

Not surprisingly, those inquiry participants that commented on these issues had divergent views. Several considered that the current tax regime does provide significant advantages to those owning or purchasing their own homes. For example, the Australian Council of Social Service (ACOSS) (trans., pp. 112-3), argued that along with perceived 'generous' tax treatment for those investing in rental housing (see below), the current 'huge tax incentives to owner occupiers' increase demand for housing, inflate house prices and reduce affordability. Some went on to comment on the inequity of perceived favoured treatment of owner occupiers over those who rent, especially as lower income earners are more likely to be longer term renters. Thus, in pointing to non-neutralities in current arrangements between owner occupiers and renters, Allan Hall stated that:

> … the main problem with the distribution of the taxation benefits of home ownership is not the ways in which they are shared between buyers and sellers in the home ownership market but that the net benefits of the tax subsidies are limited to home owners and are at the expense of renters who include a large part of the poorest members of the community. (sub. DR234, p. 4)

Although no-one specifically suggested imposing tax on imputed rental income derived from owner-occupied housing, some participants proposed that renters be 'compensated' by allowing them a tax deduction for rental expenses. There were also some calls for the CGT exemption for owner-occupied homes to be ended.

In contrast, the HIA denied that current arrangements provided a tax 'subsidy' to owner occupiers and said that a range of other considerations justify continuation of those arrangements. Amongst other things it argued that:

- no class of consumer durable is subject to taxation of imputed rental income;
- the estimated value of any 'subsidy' is grossly overstated, as owner occupiers, if subject to a similar tax regime to those investing in rental housing, would negatively gear to avoid tax;
- the social benefits that attach to housing provide a reason to support home ownership through the tax system; and
- taxing imputed rental income would have a 'very serious' impact on older home owners unable or unwilling to borrow (sub. 177, p. 13).

Likely effects of present arrangements

As noted, although owner occupiers are not subject to taxation of imputed rental income, CGT or (in most cases) land tax, current arrangements also deny them taxation deductions available to investors in rental housing, such as interest payments on loans and capital works allowances. These differences in tax treatment have two important implications:

- first, existing home owners, and those buying a family home who can finance their purchase from savings, are advantaged relative to those who need to borrow more or who are buying a rental property (whether equity or debt financed); and
- second, those borrowing to purchase an owner-occupied dwelling (often first home buyers) are potentially disadvantaged relative to highly-geared private investors in rental housing (and their tenants) — though investors bear imposts such as land tax which do not generally apply to owner occupiers.

Of course, such distinctions can often be blurred in practice. In particular, over the life cycle, most home buyers will eventually pay off their mortgages or acquire significant equity in their homes, even if they borrowed heavily to enter the market. Also, as most first home buyers rent while saving for a deposit, any tax benefits for investors will indirectly assist them to purchase a home. However, these observations do not invalidate the general proposition that the current tax regime

provides an advantage to equity investment in owner-occupied housing. This partly explains why home ownership is such an important goal for many Australians.

It follows that, in terms of the overall level and mix of investment in housing:

- the tax preference to equity investment in owner-occupied housing may lead to over investment in housing from a community-wide perspective, especially if the wider social benefits that attach to home ownership are already targeted in other ways (chapter 10); and
- the way in which housing investment is financed, and the shares of owner-occupied and rental housing, are likely to be distorted by the differences in tax arrangements outlined above.

Detailed modelling would be required to trace through the net magnitude of these sorts of efficiency effects and the accompanying distributional impacts. However, as noted above, in the time available for this inquiry, the Commission has sought to focus on the central issue of housing affordability, rather than divert attention to inherently difficult and resource intensive detailed tax modelling.

Revenue implications of change

The revenue implications of seeking to achieve greater 'neutrality' in relation to the tax treatment of owner-occupied housing would clearly depend on the approach taken. For example, greater neutrality could variously be pursued by increasing taxes on owner-occupied housing, by making rent paid deductible, or reducing taxes on returns from investment in rental housing.

Adoption of the former approach could potentially increase tax revenue. Yates, for example, estimated that revenue foregone in 2001 was as much as $22 billion. Based on recent market data, calculations by the Commission using the same methodology result in an amount of about $25 billion (see box 5.7).

But, even if judged to be an appropriate policy approach (see below), the behavioural changes that would follow from placing owner-occupied housing on a comparable tax footing to other investments, would mean much less revenue would actually be raised. For example, taxation of imputed income would reduce investment in housing and thereby revenue collected. Also, in the medium to longer term, owner occupiers would respond to taxation of imputed rental income by gearing up (not necessarily spending loan proceeds on housing), in order to establish deductions and reduce income tax. Indeed, many owner occupiers might declare a 'loss' on their house, as many rental investors currently do. Again, detailed modelling which could take account of these behavioural changes, and allow for additional tax collected in other areas in response to gearing by owner

occupiers, would be required to establish the overall revenue implications. Of course, if the government sought to make changes that were revenue neutral overall, there would be scope to reduce rates of other taxes.

Box 5.7 **Estimating the tax 'preference' for owner occupiers**

Owner occupiers are not subject to tax on imputed rental income and also receive exemptions from capital gains and land taxes. By the same token, unlike investors, they cannot claim deductions for borrowing costs, depreciation and other expenses associated with owning their properties.

A recent, widely quoted, estimate by Yates (2003) suggested that the value of this tax preference was around $22 billion for 2001. Commission estimates for 2003, using the same methodology, are similar in magnitude. However, they are based on a considerably higher valuation for the housing stock and hence the implied tax preference is smaller in percentage terms. Specifically, the Commission's calculations indicate that, subject to the important qualifications below, annual revenue foregone from:

- the non-taxation of imputed rental income is about $8 billion (after accounting for deductions such as borrowing costs, depreciation, maintenance and land taxes);
- the CGT exemption for the family home is around $10 billion; and
- exemptions from land taxes are a further $7 billion — though these taxes would be deductible were owner occupiers treated the same way as investors in rental properties. (This is reflected in the Commission's imputed rental calculations.)

However, such calculations overestimate the aggregate tax revenue likely to be raised if owner-occupied housing was made subject to these taxes. The Commission's calculations for the value of the exemption for imputed rental income assume a gearing level of around 20 per cent — reflecting the fact that many owner occupiers own their properties outright, or have very significant equity in them. But with owner-occupied housing taxed on the same basis as investment in rental housing, much higher gearing levels could be expected. Tax collections on imputed rental would thereby be reduced.

Further, these calculations are highly sensitive to short-term fluctuations in rental yields and rates of house price appreciation. Accordingly, it is also important to look at what is happening to the tax preference over time. The Commission's calculations indicate that, as a percentage of the total housing stock value, the preference has declined in recent years because:

- rental yields have trended down as real interest rates have fallen, thereby reducing the value of the exemption for imputed rental income; and
- the change to the CGT regime in 1999 has reduced the (percentage) value of the exemption for the family home.

This reduction in the percentage value of the tax preference weakens the case for policy change, especially given the likely transaction and other costs of achieving greater neutrality in the tax treatment of owner-occupied housing (see text).

Potential advantages and disadvantages of change

Modelling work undertaken by the Industry Commission in 1991 indicated that greater neutrality in housing taxation could have brought economic benefits at that time (IC 1991). However, that work was undertaken in the context of significant restrictions on the availability of capital generally, which no longer apply to anywhere near the same extent. Nevertheless, greater neutrality should still *in theory* yield economic benefits.

But there are a number of major issues which would have to be addressed before any changes in this area were seriously contemplated.

Most broadly, a judgment would be required as to whether some tax preference was justified in the light of social benefits attaching to home ownership (chapter 1) and, if so, of what magnitude. Such a judgment would need to take into account other forms of government support for home ownership (chapter 10) and how these might change over time.

A decision would then be required on how greater tax neutrality was to be pursued. For example, CGT has important deficiencies — apart from administrative complexity it can also have similar lock-in effects to stamp duty. Thus, *reducing* the application of CGT in other areas could conceivably deliver better outcomes for the community than imposing it on owner-occupied housing.

And even assuming that greater neutrality was best pursued by increasing the taxation of owner-occupied housing, a further suite of practical issues would arise:

- In particular, as has been illustrated by the experience of other countries, taxation of owner-occupied housing would have major and far reaching implications for tax administration, enforcement and compliance, with measurement of imputed rental income being particularly difficult and prone to disputation (section 5.2). Indeed, the almost inevitable exemptions and concessions would detract from the potential benefits of changes as well as further complicating administration.
- The need to match taxation of imputed rental income and capital gains with the same sort of deductions as are available to investors in rental housing would add a further layer of complexity.
- There would be significant cash flow implications for many owner occupiers, with the prospect that some low income households could experience considerable financial stress.

Moreover, seeking to achieve greater neutrality through piecemeal, rather than comprehensive, change might add to the inefficiencies and inequities arising from the current tax preferences. For example:

- Providing tax deductions to renters for rent paid would not remove the existing non-neutrality between owners with significant equity and those with large mortgages. At the same time, it could add to already existing incentives for overinvestment in housing.
- Removing the capital gains tax exemption for owner-occupied homes as a stand alone measure would in one respect improve neutrality by reducing the tax preference for equity investment in owner-occupied housing. But it would put those borrowing to purchase a family home at an additional disadvantage relative to those borrowing to invest in rental housing. The net effects on community welfare would therefore be unclear.
- Allowing deductibility of mortgage interest payments would place those borrowing to purchase owner-occupied dwellings on an equal basis with equity-financed owner occupiers. But that would increase the incentive to over-invest in owner-occupied housing.

Conclusion

Although greater neutrality in the tax treatment of owner-occupied housing offers the prospect of some efficiency and equity gains, a case for moving in this direction is not established. Apart from the likely reduction in home ownership and an accompanying loss of some social benefits, there would be major administrative, compliance, adjustment and enforcement costs in changing the current tax treatment of imputed rental income and capital gains. Also, extensive economic adjustments could follow from such a far-reaching tax change as imposing tax on imputed rental income, including significant effects on consumption, savings and investment.

At the very least, any moves to address this tax preference would require a much more thorough examination than has been possible in this inquiry as to whether the potential gains justify the costs.

Taxation of investment housing

A major theme in many submissions was that general income tax arrangements are too ‘favourable’ in their application to investment in rental housing and have thereby contributed unwarranted price pressures during the recent housing boom.

In this regard, the RBA contended that private housing investors in Australia receive more generous tax treatment than their counterparts in many other countries (see also box 5.8 and table 5.3) and concluded that:

> While [the more favourable Australian] 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. (sub. 199, p. 54)

Box 5.8 **The Reserve Bank of Australia's views on the comparative tax treatment of investment housing across countries**

> With negatively-geared 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.
>
> 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.
>
> … Under the Australian taxation system, there are no restrictions on the ability of taxpayers to negatively gear investment properties.
>
> … 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.
>
> … 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 … [in combination this can be more favourable in Australia than in other countries].
>
> … in most countries the earning of rental income is seen as the most important reason for investing in rental properties … 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.

Source: RBA, sub. 199, pp. 40–2.

Though it did 'not see a case for an outright prohibition on negative gearing for investment in residential property', the RBA highlighted three taxation arrangements affecting such investment that 'appear worthy of further examination':

- the ability of investors to negatively gear an investment property for many years;
- the benefit arising from capital works deductions due to differences in income and capital gains tax rates; and
- the general treatment of property depreciation (sub. 199, pp. 54–5).

In a submission made prior to the release of the Discussion Draft, Professor Cameron Rider and Miranda Stewart of the Melbourne Law School claimed that current tax arrangements cause significant distortion:

> The combined effect of a number of the tax reforms made in September 1999 has been to create a significant distortion of investment incentives in favour of negatively geared residential property investment. (sub. 206, p. 2)

They contended that the main problem with the current regime is 'the unique and highly preferential *combination* of the unrestricted negative gearing benefit and the CGT discount benefit' (sub. 206, p. 7, emphasis in original). They went on to suggest that the key to a solution is to:

> … recognise that the interest expense on the property is being incurred in part to earn the rental income and in part to earn the discounted capital gain on sale. (sub. 206, p. 7)

Rider and Stewart proposed two broad reform options for consideration: a phased-in moderation (but not total removal) of the unrestricted negative gearing benefit for residential property investors; and a partial recapture of the negative gearing benefit on sale of the property. In a second submission, responding to the Discussion Draft, Rider suggested another approach designed, as he saw it, to put negatively geared property investment on the same tax footing as a negatively geared investment in equities:

> The CGT discount should be expressed to apply to property investment in the same way as it applies to equity investment, i.e. it should only apply to so much of the capital gain on sale as represents the excess of sale proceeds over the initial acquisition cost. To the extent that sale proceeds recoup depreciation and capital works deductions, those proceeds should be treated as normal non-discounted income. (sub. DR275, p. 10)

Similar themes are also evident in a recent discussion paper prepared by Professor Peter Abelson for CPA Australia:

> … although the income and capital gains tax provisions are not housing specific, they nevertheless have a particularly large impact on the housing sector and especially on house and unit prices … there would be advantages in tax provisions that provide tax relief for real rather than nominal income losses and that tax real income and capital gains. (CPA Australia 2004, p. 3)

Changes were also proposed by a number of other participants concerned that taxation arrangements have magnified the recent housing boom. For example:

- ACOSS suggested that negative gearing should, in the medium term, be abolished for shares, property and collectables (sub. 147, p. 20);
- Uniting Care NSW stated that capital gains tax concessions on the sale of investment properties should be abolished (sub. 150, p. 9);
- the Australian Consumers' Association recommended reversion to the pre-2000 system of CGT, disallowance of deductibility of the inflation component of

interest on borrowings, and allowing deductions for interest payments only against investment income (sub. 122, pp. 18–19); and

- the Australian Workers' Union considered that if concessional capital gains tax continues to apply, then it may be appropriate to limit the tax benefit associated with negative gearing losses to a maximum of 24.25 cents per dollar of loss (sub. 170, p. 8).

Participants from the social welfare and union sectors expressed particular concern about the equity implications of current tax arrangements, including the effects on lower income people in rental accommodation or seeking to buy their first home. For example, the CFMEU argued that:

> … these measures [negative gearing and changes to CGT] are significant public subsidies to investment in property, and serve to exacerbate a housing bubble, fuelled largely by inflated unit prices in the inner city. The speculative frenzy around investment property is driving up prices, and having a significant impact on affordability. (sub. DR255, p. 5)

However, participants from the housing sector argued that changes to the tax arrangements affecting investment in rental housing are not justified. The HIA commented:

> Interest is a deductible expense for any income producing asset. Hence the negative gearing of any investment is not regarded as a distortion to the tax system and does not appear as a tax expenditure in the Federal Budget. Moreover, full interest deductibility has been available for investment in any income producing asset, except for a brief period in 1985 to 1987, so it is difficult to consider why it should suddenly become a significant contributor to declining housing affordability. (sub. 177, p. 13)

Similarly, the REIA considered:

> Removal of negative gearing would discriminate against the real estate industry … and it would remove an important incentive to assist Australians to create wealth by investing in property … including self-funded retirement for their benefit and the benefit of the nation. (sub. 124, p. 14)

And the Property Council of Australia commented:

> Any restrictions on negative gearing would also create further tax-induced inefficiencies among the investments held by investors, and would be almost impossible to implement in a simple and cost effective manner. (sub. 194, p. 33)

Does income tax treatment discriminate in favour of investment in rental housing?

On a simple tabular comparison of tax measures applying to investment in rental housing across a range of countries (see table 5.3), Australia's provisions do appear relatively favourable. But, as previously discussed, whether this is so in reality

depends on a range of factors — not included in that simple comparison — such as pre-tax rates of return for particular assets (which can vary cyclically), the length of time for which an asset is held, the level of interest rates and the individual investor's marginal tax rate.

In any event, the apparent generosity of Australia's provisions compared with those in other countries is not the key policy consideration. From an efficiency and housing affordability perspective, what is at issue is whether the Australian tax regime encourages inefficient or excessive investment in rental housing. That depends not on whether the tax treatment of rental housing in Australia is more or less favourable than in other countries, but rather on how rental housing is taxed relative to other types of investment in this country.

Several interconnected aspects of Australia's tax regime are relevant in this context; namely, income tax rates, negative gearing rules, provisions for depreciation and capital works deductions and the CGT arrangements.

As noted above, Rider and Stewart considered that investment in rental housing is favoured by a 'unique and highly preferential' combination of unrestricted negative gearing and the CGT discount available to individuals (who are responsible for the bulk of investment in this area). But they acknowledged that passive investments in shares can also benefit in this way:

> Possibly, the only other type of common non-debt investment which is capable of producing the unique combination, of a CGT discount benefit and unrestricted negative gearing, is a passive investment in shares, because shares also produce income in the form of dividends. (sub. 206, p. 5)

The Commission further notes that it is easy to borrow for investment in shares. The investor's own home can be used as security. As well, margin lending and protected equity loans also allow investments in shares to be heavily geared. Thus, it is not correct to assert, as some have done, that rental housing investment is unique in the manner and extent to which it can be geared.

In responding to the Commission's Discussion Draft, Rider further contended that the capital works deductions favoured investment in rental housing over investments in other assets such as shares:

> These [capital works] deductions are, of course, not available in respect of equities. Only property investments offer these deductions for part of the capital cost of the investments. (sub. DR275, p. 3)

These issues were explored in some depth at the public hearings. Following discussion with the Commission, Rider accepted that although not as immediate as for those investing in residential property, the same tax benefits are effectively

available to those who invest in commercial property through property syndicates, unit trusts and listed entities in infrastructure and utilities:

> … the tax advantages I have said are present in rental property would equally apply if you were to invest in commercial property. When you invest through a unit trust you would get the negative gearing deduction for the interest expense if you geared up. You wouldn't get direct access to the capital works and depreciation deductions. They would remain in the trust and the benefit of those would come through in the cash flow distributed by the trust … having a tax-free component. (trans., pp. 386-7)

Rider further acknowledged that the many small businesses which operate as individuals, rather than companies, can also receive the benefits of capital works deductions. Similarly, companies can pass on the benefits of any capital works deductions (and depreciation) to their shareholders through larger dividend distributions or an appreciation in the price of their shares.

In the light of this discussion, the Commission therefore reaffirms its conclusion in the Discussion Draft that income tax arrangements in principle are broadly neutral between private investment by individuals in rental housing, equities, and (including via unit trusts, property syndicates, etc.) in commercial property. In each case, investors can benefit either directly or indirectly from negative gearing, depreciation and capital works deductions, and the CGT discount.

This is not to suggest that the tax arrangements are equivalent across these different types of investment in the dollar benefit they confer on investors. For example, the direct benefits from capital works deductions to a private investor in housing might be greater than the indirect benefits for an investor in a pharmaceutical company (say) given the latter's more diverse capital assets. But such differences in benefit are not of policy concern in themselves. It would not be sensible to argue, for instance, that fire fighters should be denied deductions for the cost of purchasing fire-proof clothing, simply because few other taxpayers could claim such a deduction. In the Commission's view, taxation arrangements should aim for neutrality in *application* rather than, as some submissions implied, neutrality in *effect*.

Inefficiencies will arise, however, if individual tax provisions as they apply to *all* investments are overly generous. In this case, they will tend to magnify any surges in investment in particular asset classes due to factors other than tax. As discussed in the next section, the recently modified CGT arrangements appear especially problematic in this regard.

Are there distortions in individual tax provisions?

Negative gearing provisions, capital works deductions and the CGT discount were all targeted by those concerned about perceived overinvestment in rental housing and its contribution to recent increases in house prices (see above).

Yet, when judged against some 'standard' tax efficiency benchmarks, it is far from clear that there is a fundamental problem with the first two of these.

- Negative gearing facilitates risk-spreading among investments. In principle — and leaving aside tax avoidance issues — it would seemingly be both inefficient and inequitable to tax the returns from an investment in the year of gain, but not allow deductions that reduce an individual's income in the year of loss. Negative gearing also provides neutrality between investors who borrow and those who use their own equity.
- Were negative gearing more confined in its application, tax arrangements would then favour investment in income-producing assets at the expense of riskier growth assets without the income yield to cover immediate expenses.

In any case, even if the tax treatment of capital gains is 'generous' relative to the taxation of income, preventing negative gearing would not deter borrowing up to the point where no net current income was earned. Tax could still be deferred until capital gains were realised, with tax paid under the more generous CGT provisions. Moreover, removing negative gearing for housing investment alone could induce a potentially costly reallocation of investment portfolios, without necessarily having major effects on overall investment flows (see, for example, Sieper 1986, pp. 279-314).

Denying capital works deductions for buildings (or depreciation on fittings and fixtures) would similarly conflict with the principle that the costs of generating taxable income should be deductible.

However, the capital works deduction provisions and the current CGT arrangements do serve to illustrate the compromises necessary in moving from principles to practice, and the potential inefficiencies that can arise.

Putting aside the more fundamental question of whether taxation of capital gains is necessary if income and consumption are also taxed, a 'neutral' income tax system would tax (real) capital gains on a full accruals basis year by year, rather than on a nominal basis, on realisation, with a 50 per cent discount. It would also allow full deductions in respect of capital losses, rather than, as at present, just against capital gains.

An accruals-based regime would, of course, be extremely difficult to implement, raising a raft of revenue, administrative, compliance and transitional issues. The need to tax on a realisation basis may in turn support some discounting of CGT liabilities to reduce lock-in effects, as might a desire to encourage private individuals to invest in higher risk companies. Also, as Rider noted, '… so long as capital losses are not fully deductible, there is a certain equity in some kind of concessional treatment for capital gains' (trans., p. 391).

Clearly, the 1999 change in the basis for levying CGT, being more or less coincident with the decline in returns from equities, has added to the recent housing price boom by encouraging investors to reduce current income in favour of longer term capital gains. For the reasons just outlined, given a nominal basis for CGT, there may well be some justification for allowing a discount. But even if this is so, a question remains as to whether the current level of discount is appropriate, either from a general efficiency viewpoint, or in terms of the original 'pro-investment' rationale for change (section 5.1).

The relationship between 'economic' depreciation and the rates claimable for tax purposes is another relevant issue in assessing whether the current tax regime is leading to inefficient investment in rental housing and other assets. If rates of depreciation for tax purposes exceed economic depreciation, then excessive investment in rental housing is likely to be encouraged. However, given the heterogeneity of the housing stock, differences in economic life between residential, commercial properties etc, setting rates of capital works deductions which mesh exactly with the circumstances applying to an individual building, or even certain property types, will be extremely difficult. The compromises necessary may, in turn, give rise to a 'second best' argument for modifications to other aspects of the tax regime.

In sum, aspects of the current tax regime governing investment in housing and other assets have the potential to reduce housing affordability and lead to otherwise inefficient outcomes. As always, however, the real issue is whether there are practical changes that could improve on current outcomes.

The way ahead

In the Discussion Draft, the Commission suggested that these broader tax issues, and options for dealing with them, would need to be assessed in a review covering all the possible ramifications, rather than in a housing-specific context. However, it was ambivalent about the appropriate timing for such a review.

Several participants endorsed the need to consider general tax measures impacting on investment in rental housing in a broad context. The RBA commented:

> Any changes in … arrangements 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. (sub. 199, p. 6)

And, in responding to the specific review proposal in the Discussion Draft, Paul Pollard stated:

> The draft report states correctly that tax changes need to be considered in the broader context of each tax, not just in relation to housing affordability. However it must be recognised that given the nature of Australian household wealth, the effect on the housing market of this tax [capital gains tax] [is] a very large part of that broader context, and a very strong ground for calling for a review of it. (sub. DR253, pp. 6-7)

Other participants who endorsed the review proposal included ACOSS (trans. p. 107) and the Council of Social Services of NSW (trans. p. 236), with the latter suggesting that the review also encompass state-level taxes. And while not specifically endorsing a review, CPA Australia suggested that '… more work on this and other tax scenarios, including lower marginal tax rates, is required' (sub. DR319, attachment, p. 3).

But others explicitly, or implicitly through their suggestions for change (see above), called for more immediate action. In this regard, Rider implied that a general review is unnecessary given the recent Review of Business Taxation (the RBT or Ralph review) and that the 'real problem which needs to be addressed is a comparatively narrow one': ie what 'fine-tuning of the … CGT discount needs to be made' (sub. DR275, p. 10). He added:

> The fear that you shouldn't change anything because you might have to change something else is extremely laudable. It's not really borne out by the experience of tax reform. I think, in reality, we have to accept that it is a system which starts not from a plain piece of paper but has anomalies already well embedded and we spend our life trying to deal with one anomaly to keep things going. (trans., p. 390)

That said, Rider acknowledged that tax changes designed to alter behaviour in the housing market would flow through to other forms of investment:

> I'd have to agree, of course, that any change you make at any level will have implications in other areas. (trans., p. 388)

The Commission accepts that it is possible that some piecemeal changes to current taxation arrangements *may* deliver more affordable and efficient housing market outcomes. However, the preceding analysis illustrates that not only are the issues complex, but that any changes could not be quarantined to investment in rental

housing. Indeed, ostensibly simple ‘fixes’ — such as abolishing CGT discounts for residential housing investment — could have far-reaching implications.

Nevertheless, it seems likely that changes to these arrangements, as they apply to all asset classes, could improve the efficiency of investment outcomes. Assessing such changes, however, is beyond the scope of an inquiry looking at a wide range of influences on house prices and housing affordability. Thus, as the Commission argued in its Discussion Draft, what is required is a broad review covering all of the relevant tax arrangements and the complex interactions among them. Such a review would have the opportunity to draw on the Government’s current investigation of the appropriate tax treatment of capital works deductions for buildings, and to take into account any changes that ensue. (As noted above, the Australian Government has announced that any changes would not come into effect before 1 July 2005 (Coonan 2002).)

The initial focus of the review should be on the merits of changing CGT arrangements. The interaction of the CGT with high marginal tax rates boosts the incentive to reduce income and delay tax payments until capital gains are realised. In the Commission’s view, it is those arrangements, rather than access to negative gearing or capital works deductions, that give rise to most of the potential for inefficient investment. Subject to the outcome of the current investigation of capital works deductions, the review should also look at the relationship between economic depreciation on buildings and the rates of depreciation allowed for tax purposes.

Further, if practical reasons were to militate against change to the CGT regime or capital works provisions, the review would need to look at the merits of ‘second best’ options for delivering more efficient investment incentives, including:

- more restrictive negative gearing provisions; and
- removing the CGT discount for that part of the gain previously claimed as a capital works deduction against current income (though again any changes from the current investigation would be relevant here).

The appropriate timing of such a review remains a matter for judgment. On the one hand, holding a review near the top of the housing cycle could exacerbate any future market downturn. As well, there is as yet no experience of how the effects of the recent tax changes will play out over the whole housing cycle, nor of their influence on investment outcomes as returns on equities improve relative to housing. On the other hand, the complexity of the issues means that the review could take considerable time. Further, the implementation and transitional issues inherent in major changes to tax law mean that any policy changes ensuing from the review would not be in operation for some time. On balance, the Commission can see no reason for delaying the establishment of the review.

In the interim, making housing-specific changes to taxation arrangements would run the risk of adding to existing distortions, or creating new ones, rather than improving the neutrality and efficiency of tax arrangements.

RECOMMENDATION 5.3

The Australian Government should, as soon as practicable, establish a review of those aspects of the personal income tax regime that may have recently contributed to excessive investment in rental housing. The focus of the review should be on the Capital Gains Tax provisions. However, it should also assess 'second best' options for addressing distortions in incentives to invest in housing and other asset markets, including: restrictions on negative gearing and changes to the capital works deduction provisions for buildings. Pending such review, it would not be appropriate to make housing-specific changes to negative gearing rules or to capital gains tax arrangements.

6 Has supply got tighter?

Findings

- Constraints on the supply of land at the urban fringe have contributed to housing price pressures, particularly in Sydney.
  - However, because recent price increases have been due mainly to the surge in demand in established areas, improvements to land release policies or planning approval processes could not have greatly alleviated them.
- Land release requires long lead times and needs to be informed by strategic planning in all jurisdictions. Such planning should involve public scrutiny of key assumptions about costs and benefits of different options. The tradeoffs between greenfield development and urban consolidation should be a key focus of the strategic planning process.
- Urban consolidation policies that introduce constraints on fringe development, including through 'urban growth boundaries', are likely to increase the scarcity value of land. Their effects on housing affordability depend on the scope to increase housing densities. This may have been overestimated.
- Current reviews of development approval processes have been concerned with problems of excessive 'red tape' and unnecessary delays. These reviews are better placed than this broader national inquiry to identify specific reforms to address such problems.
- Nevertheless, as part of this reform process, priority areas for government attention include the scope to:
  - achieve greater separation of policy making and administration;
  - streamline permit approval processes to enable minor or uncontentious developments to by-pass unnecessary informational or consultative requirements;
  - improve or expand 'as of right' development provisions, without detracting unduly from the property rights of existing residents; and
  - reduce delays in appeal mechanisms, while maintaining the protections of due process.
- A precondition for effective reform are clear rules that have been developed through community consultation and have broad support. It is also important that all reforms are adequately scrutinised in advance and that their effectiveness is subsequently monitored.

The recent increase in house prices raises questions about whether supply has been unduly constrained in responding to greater demand, especially in the past few years. Industry representatives claim that the surge in prices has been largely attributable to government policies constraining the supply side. The most significant problems cited — policies relating to land release and development approval processes — are examined in this chapter. Other potential supply-side problems, concerning housing-related infrastructure charges and aspects of the operating environment of the building and dwelling construction industries, are examined in subsequent chapters.

The supply of additional housing stock is typically provided by building new dwellings on greenfield land, which pushes out the urban fringe, or on dispersed infill or major redevelopment sites, which increases the intensity of land use in established areas.

Supply lags are an inherent feature of land development and dwelling construction. Housing supply cannot immediately respond to demand surges because of the lead times needed to service lots, to redevelop land and to construct dwellings. Industry representatives indicated that it can take several years for 'developable land' to be converted into construction-ready lots with roads, drainage, water supply, sewerage and electricity services in place.

In the long term, supply is more responsive, but even large increases in the average production level of dwellings can have only modest effects on the stock of housing. Net additions to the total dwelling stock rarely exceed 2 per cent per annum.

In the presence of a demand surge such as that from the mid-1990s, the inherently slow supply response can result in large price increases. Increased demand will boost prices of established housing as owner occupiers try to trade up, given that the availability of land for housing in premium locations often cannot be expanded at all. This has been a dominant influence in the recent upswing.

Even so, a key question is whether the price raising effects of such inherent delays and constraints have been compounded by government restrictions and regulations on land use — either at the fringe or within cities.

6.1 What is the evidence?

In seeking to understand the nature of the supply-side contribution to rising house prices, it is useful to look first at trends in the price of different components of a dwelling — and in particular, what part of the overall trend is attributable to the

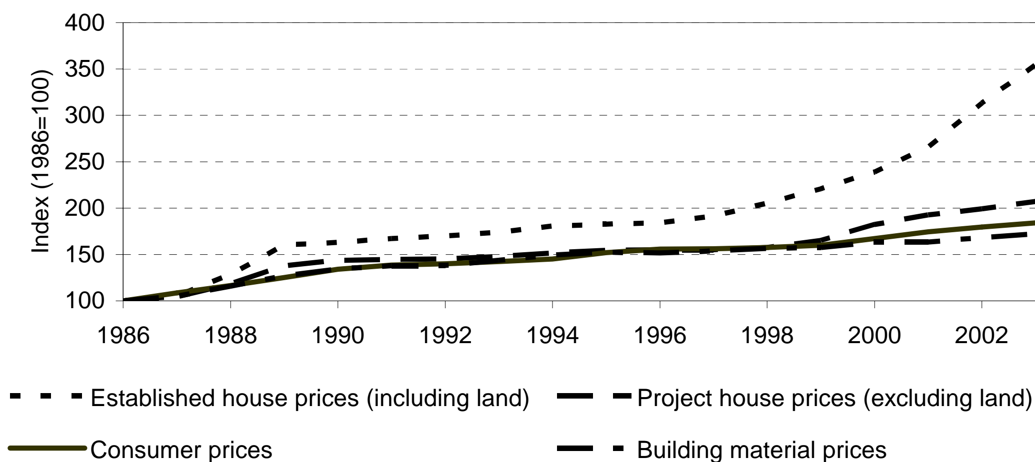
rising value of land. These changes can be juxtaposed against trends in the number of lots and dwellings supplied, including comparisons with underlying demand.

As noted in chapter 2, some of the increase in house prices can be attributed to improvements and renovations to the existing housing stock. A number of participants pointed out that the average size of new houses has been increasing and the quality of fittings improving. But these changes are gradual and they are likely to have had a minor role in the price surge since the mid-1990s.

Another possible cause of rising house prices could be increasing building costs. However, as Caplin, Joye et al. (2003) observed, building material prices have generally risen at similar rates to the consumer price index (see figure 6.1), suggesting that the main contributor has been rising land prices.

This is further demonstrated by comparing the ABS index of prices of 'established' houses (including land) with the index of the prices of project houses (excluding land), which is shown at the national level in figure 6.1. The growing divergence between the two can be attributed to faster growth in the price of land. The trend is strongest in Melbourne and Sydney, but is apparent in most capital cities.

Figure 6.1 **Trends in house and building material prices**

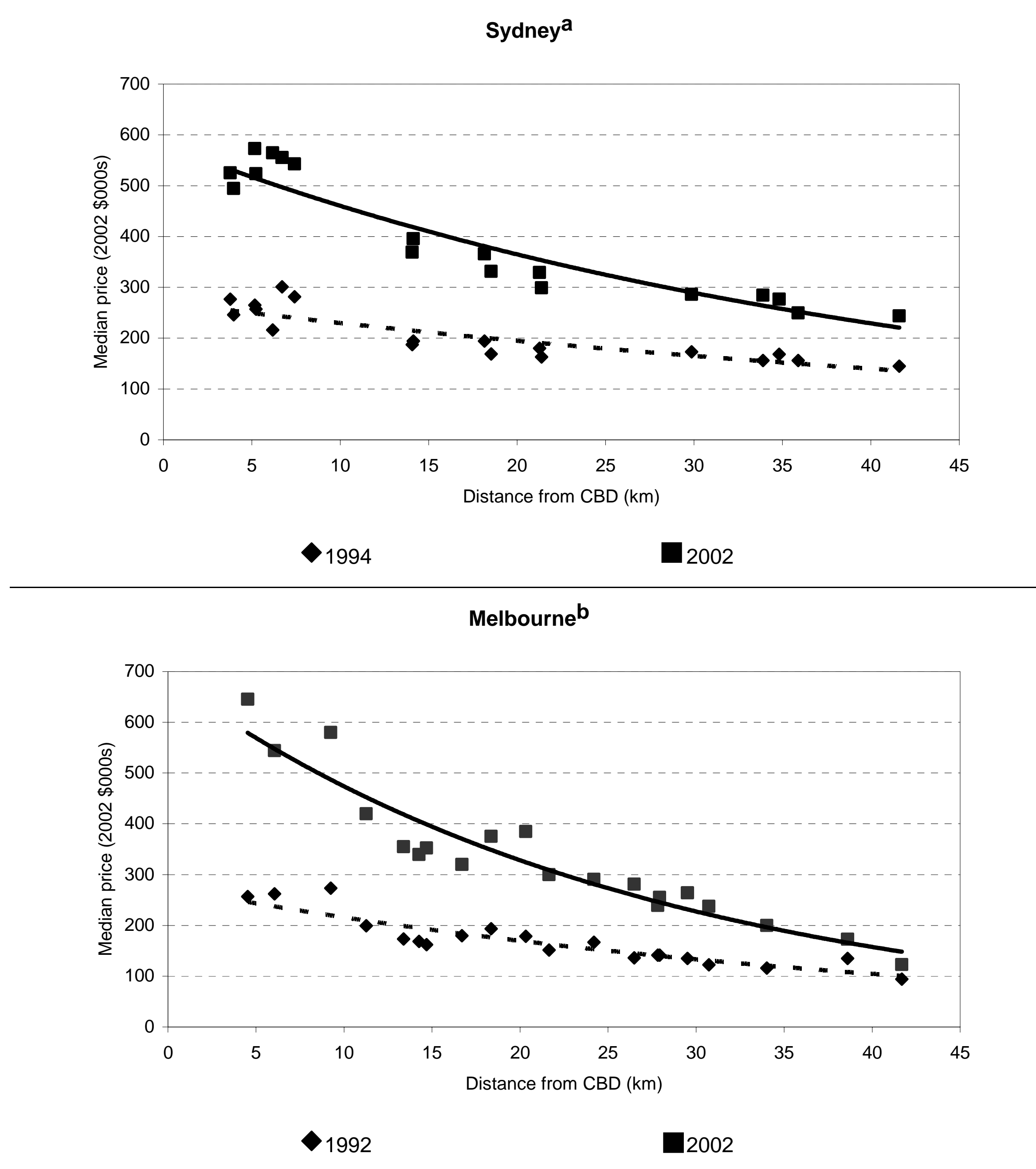


Data sources: ABS (*Consumer Price Index, Australia*, Cat no. 6401.0; *House Price Indexes: Eight Capital Cities*, Cat. no. 6416.0).

There is evidence of a growing preference for centrally located land within expanding cities. For example, along transport corridors in Sydney and Melbourne, the change in median prices from the early 1990s to 2002 was proportionately greater close to the central business districts of each city than at the fringe (see figure 6.2). In Sydney, the real median house price five kilometres from the city

increased by more than 100 per cent, while at 40 kilometres it increased by less than 50 per cent.

Figure 6.2 **Price 'gradients' in Sydney and Melbourne**



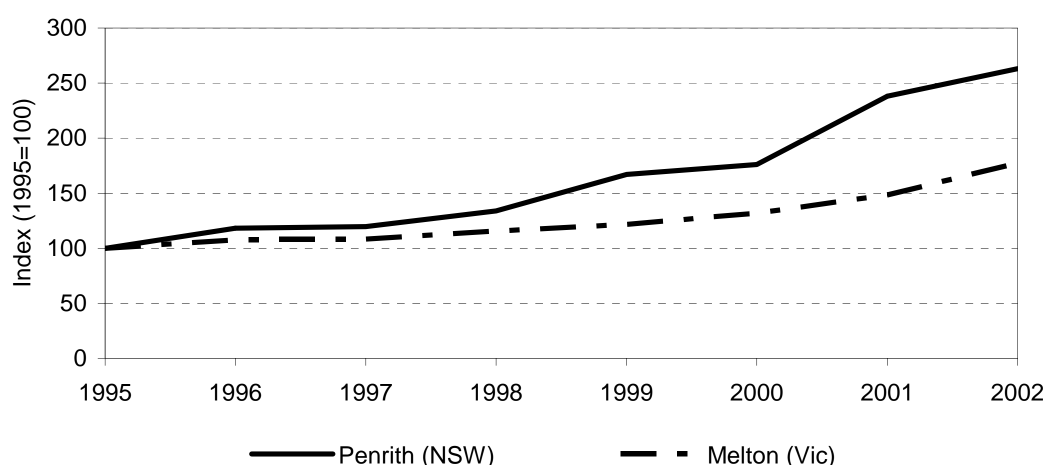
[a] The 18 suburbs shown for Sydney are adjacent to the Campbelltown line. [b] The 22 suburbs shown for Melbourne are adjacent to the Nepean Highway.

Data sources: DSE (2003a); NSW Department of Housing.

This trend is consistent with rising house prices being primarily due to the inherent scarcity value of land in established areas, which has risen as demand has increased.

However, the Commission's examination of price information for vacant blocks located at urban fringes also reveals some substantial price rises. For example, the price of a block of land in Melton Shire (Victoria) has almost doubled since 1995, and the price of a vacant block in Penrith (NSW) has much more than doubled (see figure 6.3). If anything, the chart may understate the rate of increase, as lot sizes have been shrinking in this period.

Figure 6.3 **Median vacant block price trends at the 'fringe'**



Note. Prices are in nominal terms.

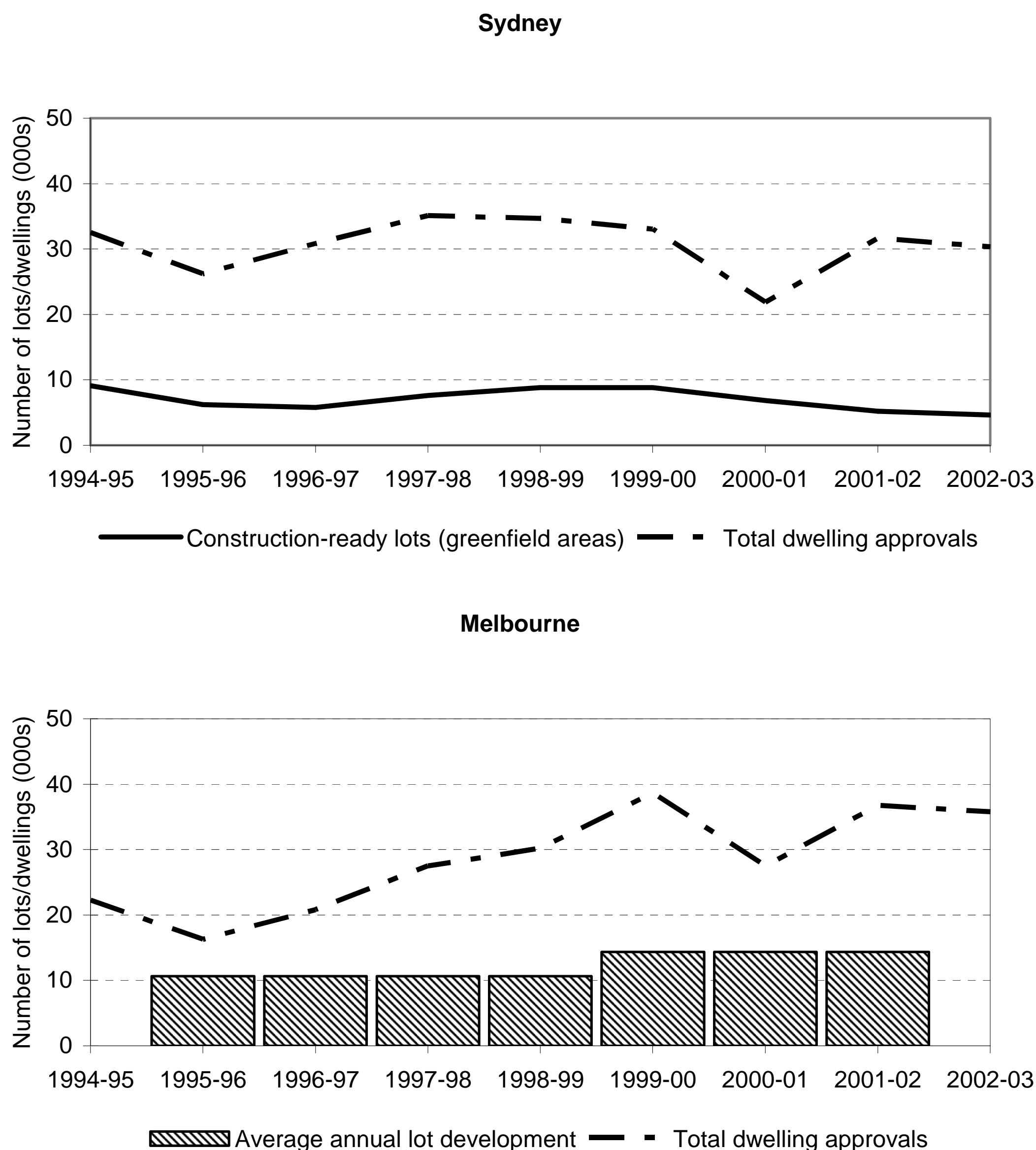
Data sources: Australian Property Monitors (unpublished); DSE (2003a).

Another means of identifying potential supply problems is to examine trends in the supply of construction-ready greenfield lots and new dwellings. Data from Sydney and Melbourne are presented in figure 6.4.

In Sydney, the number of dwelling approvals has remained relatively stable, while completion of construction-ready greenfield lots in 2002-03 was at its lowest level in eight years. The decline in the number of greenfield lots produced has forced a greater reliance on infill developments, where planning objections and delays are more prevalent (section 6.3).

In Melbourne, the available information suggests that aggregate supply may have been somewhat less constrained than in Sydney (see figure 6.4). There have been trend increases in dwelling approvals and, to a lesser extent, greenfield lots since the mid-1990s.

Figure 6.4 **Trends in 'greenfield' lot production and dwelling approvals, Sydney and Melbourne**



Note. Dwelling approvals are the total number of private dwellings approved, which includes both single detached houses and the total number of multi-unit dwellings. Average annual lot development is an estimate of the number of greenfield construction-ready lots (DSE, pers. comm., 1 December 2003).

Data sources: DIPNR (2003a); Victorian Government (sub. 85, appendix D, table D1); ABS (*Building Approvals, NSW*, Cat. no. 8731.1; *Building Approvals, Victoria*, Cat. no. 8731.2).

Sydney can be distinguished somewhat from other cities in that the number of housing approvals is dominated by multi-unit dwellings, which far exceed the production of construction-ready lots in greenfield areas. The trend to multi-unit developments could partly be a response to undersupply of greenfield lots. However, an increasing preference to live in high-density housing closer to amenities is also likely to have been influential. For example, part of the investment

surge in inner-city apartments has catered for increasing numbers of overseas students and temporary business visitors (chapter 4).

The existence of a small overall shortage in the supply of new dwellings finds some support in estimates of the gap between underlying demand (based on population and household formation trends) and private and public dwelling completions. BIS Shrapnel data indicate a shortfall in dwelling completions in most jurisdictions over the last seven years, but particularly so in NSW and Queensland (see table 6.1). However, the differences between aggregate dwelling completions and underlying demand are not large. For example, in NSW the shortfall represents about 5 per cent of total underlying demand for the period. In Victoria, underlying demand and supply appear broadly in balance, even though prices in Melbourne and some regional areas have risen sharply in recent years.

Table 6.1 **Difference between dwelling completions and underlying demand estimates, 1996 to 2003**

000's of dwellings

	NSW	*Vic*	*Qld*	*WA*	*SA*	*Tas*	*ACT*	*NT*	*Australia*
Completions	307.7	255.2	220.6	52.2	122.4	11.9	10.5	13.9	994.4
Underlying demand	323.2	256.4	243.2	52.5	126.0	13.0	7.4	14.5	1036.2
Shortfall	-15.5	-1.2	-22.6	-0.3	-3.6	-1.1	3.1	-0.6	-41.8

Note. Underlying demand is estimated using historical relationships between population and household formation and rates of demolitions.

Source: BIS Shrapnel (2003).

The population and immigration data used for estimating underlying demand, present some difficulties. Specifically, the population estimates used by BIS Shrapnel do not include people who stay for less than a year, but who nevertheless may demand housing. An offsetting consideration is that the most recent population estimates employed by BIS Shrapnel use net immigration figures that are higher than the latest ABS estimates (chapter 4).

In any case, aggregate state-level data can hide demand-supply imbalances in metropolitan or regional areas, or within particular segments of the metropolitan market. For example, the construction of inner-city apartments may not relieve shortages of housing suitable for first home buyers.

Although there appears to have been a shortfall in housing supply at the urban fringe — at least in Sydney — it is the increased demand for existing dwellings in established areas that has been the primary reason for recent price rises. As highlighted in figure 6.2, there have been substantial variations in the rates of price increase across suburbs in the major cities over the past decade, with the greatest

increases being in suburbs close to the central business districts, where land is most scarce.

That said, the impact of demand pressures on land prices may well have been accentuated by rigidities in the supply chain, such as government interventions which unduly limit the supply of additional land at the urban fringe or the construction of additional dwellings *within* cities. Land release arrangements and the processes for approving developments in greenfield and infill sites are clearly relevant in this regard. A particular issue for this inquiry is whether these processes have changed such as to *reduce* the responsiveness of supply and thus compound price pressures from strongly growing demand.

6.2 The supply of 'new' land

Traditionally, Australian cities have accommodated growing populations through expansion at the fringes. As a result, Australian capital cities cover large areas and have among the lowest city population densities in the world. Over the past 10 to 15 years, governments have sought to control the resulting 'sprawl' by encouraging higher density redevelopments within established areas, in order to achieve better use of existing economic and social infrastructure.

Industry participants in this inquiry contend that such policies have served to reduce the supply of new land and have thereby contributed to rising prices and declining housing affordability. As noted in the previous section, land prices in a number of fringe locations have increased rapidly, although some have argued that this partly reflects an increase in the cost of providing services to building lots (chapter 7).

Aspects of policy bearing on land supply and some related issues are examined in this section. A key question is the impact of such policies on housing affordability. However, it has not been possible for the Commission to review the diverse arrangements across jurisdictions in any detail. There are also important social and environmental dimensions to policy in this area to be taken into account, as well as economic costs and benefits. The Commission has therefore focused on some high level issues which are crucial to ensuring that land release processes are efficient and effective in all jurisdictions.

Current processes in brief

The supply of housing lots created from 'greenfield' land (for example, existing farmland) depends on:

- the land being re-zoned for future residential development; and

- the timely provision of trunk infrastructure to allow such re-zoned land to be subdivided into serviced lots.

State and territory government approaches to urban development differ widely (see box 6.1). Strategic planning — taking economic, environmental and social objectives into account — underpins these approaches to varying degrees. The planning process generally involves some consultation with the public. Plans are usually updated from time to time, to take account of changing economic circumstances and community priorities.

Box 6.1 **Examples of current land release policy**

- In Sydney, land for future urban development is identified through metropolitan and regional planning strategies. Following detailed investigation of service availability, transport and environmental issues, the land is re-zoned in liaison with local councils and relevant government agencies. Since 2001, it has been government policy that release areas accommodating more than 1000 dwellings must include mechanisms to fund regional transport and other infrastructure. Apart from already committed release areas around the metropolitan fringe, two large sectors in the north–west and south–west of Sydney are currently under investigation as potential new urban communities (Department of Infrastructure, Planning and Natural Resources, Sydney, pers. comm., 18 March 2004).
- In Melbourne, land is first identified for urban development without any formal changes to zoning. Under the strategic development plan *Melbourne 2030*, preferred development sequences are to be defined in designated growth areas, to provide better coordinated infrastructure planning and funding. According to *Melbourne 2030*, this has to include an indicative 10 to 15 year development and land supply program, regularly updated, to identify the areas (both greenfield and major infill redevelopment sites) in which development is expected to meet projected housing demand.
- In Queensland, land for future development is identified by the publication of land-use and trunk infrastructure development plans. Local governments release land for urban development after satisfying broad state government land-use and infrastructure planning objectives.

A major economic concern in all jurisdictions is the cost of providing infrastructure. Most plans are predicated on the objective of ensuring more efficient use of existing urban land and services by constraining urban sprawl. Some governments have imposed an explicit ‘urban growth boundary’ to implement this objective (discussed below).

Governments generally monitor land supply using a ‘balance sheet’ approach. In forecasting demand, attention is given to the intensity of land use and the extent to

which expected housing demand is likely to be met by dispersed infill and major redevelopments.

Whether these strategic plans promote efficient consumption of housing services, depends on whether they are based on a robust analysis of benefits and costs. Developing strategic plans is a complex process, depending on many assumptions. Consequently, the resultant strategies necessarily involve a considerable element of judgment. This makes public consultation and good process critical elements in effective decision making.

Is fringe supply unduly constrained?

There was broad agreement among inquiry participants that to avoid speculative pressures and to promote efficient production, it is desirable that sufficient undeveloped land be designated for future residential use to meet around 15 years' projected demand. The Urban Development Institute of Australia (Victoria) (UDIA, sub. 121) contended that, at the next level, some five years of supply of 'developable land' (serviceable by infrastructure providers) is necessary to cope with sudden increases in demand, with 18 months to two years of completed stock 'on hand'.

Governments have generally endorsed the need for 15 years' fringe supply, but consistent with a desired shift to more compact cities, have anticipated in their planning that over time a rising share of total supply will come from infill development. The NSW Government observed:

> From the late 1970s up until early 1990s, more than 40 per cent of the additions to dwelling stock each year in metropolitan Sydney were located in new greenfield areas. That share has dropped significantly since 1993-94 to an average of 28 per cent for the period 1996 to 2001. It is projected to fall further to 25 per cent over the next five years. (sub. 187, p. 30)

Constraints in Sydney

Sydney has its own problems, being:

> … physically hemmed in by the Blue Mountains to the west and a string of national parks on its flanks. In addition, all prospective development on the existing urban frontier drains into the Nepean/Hawkesbury river system, a system vulnerable to pollution. (Birrell and Healy, 2003, p. 51)

The Property Council of Australia (PCA) (sub. 194) and the Housing Industry Association (HIA) (sub. 177) whilst acknowledging physical constraints, argued that the supply of new lots in Sydney has been inadequate and also falls short of

what will be needed to meet underlying projected demand for some 27 000 dwellings per year. The more restricted supply in Sydney is evident in figure 6.4, even allowing for a higher level of infill development compared with Melbourne.

The NSW Government noted that it has recently taken initiatives to make more greenfields land available for housing, including investigating the release of over 20 000 hectares of land in south– and north–western Sydney (see box 6.1). This response further suggests that supply has been inadequate in recent years.

Constraints in Melbourne

In Victoria, some controversy has centred on the imposition of an 'urban growth boundary', as part of the *Melbourne 2030* strategic plan (see box 6.2). The boundary is part of a strategy to 'manage' development at the urban fringe and encourage more dense development both in established and designated growth areas. An urban growth boundary has existed in Perth for some time, with a boundary adopted in Adelaide in May 2003.

The Victorian Government has stated that some 15 years supply of land was encompassed within the original plan. Nevertheless, prices for broadacre land within the urban growth boundary increased sharply just after it was implemented.

According to the UDIA (Victoria) (sub. 121), these price increases resulted from industry uncertainty about the scope to relax the urban growth boundary over time, leading to *perceptions* of potential supply shortages. However, the Victorian Government contends that the price increases were due to a number of factors, not least a rapid rate of land take-up associated with high levels of housing demand and greater competition from large, interstate land developers (sub. DR301, p. 6).

The Victorian Government has recently completed its Urban Development Program review and released an additional parcel of residential land in the Hume growth area, with the effect of extending the urban growth boundary in that area. However, the UDIA argued that a longer-term strategy that identifies corridors where future expansion will occur is required, rather than periodic incremental extensions of the boundary.

Box 6.2 **The Melbourne 2030 urban growth boundary**

Melbourne’s urban growth boundary was established as part of a broader strategy. Its stated purpose is to:

- set clear limits to metropolitan Melbourne’s outward development;
- concentrate urban expansion into areas that are served by high-capacity public transport;
- manage the sequence of development in growth areas so that services are available from early in the life of new communities; and
- protect the green wedges of metropolitan Melbourne.

The plan was developed in consultation with a reference group comprising representatives from local government, peak industry bodies and community-based organisations and professional experts.

Two principal goals of establishing a boundary are to produce an urban form that can be serviced efficiently by making best use of existing infrastructure and to give long-term certainty about growth areas, to minimise speculative pressures on land values in nearby areas.

In areas other than the designated growth areas, the intention is to set the boundary permanently, following consultation on the implementation of the plan. In the designated growth areas, the boundary will be set on completion of the review of development plans for each area.

Future variations to the urban growth boundary are expected to occur after periodic reviews of the growth area plans and assessment of land supply levels. It is claimed that the urban growth boundary, as proposed, includes enough land for development to provide for metropolitan Melbourne’s needs in the future, given the redirection of priorities.

Source: DoI (2002).

The Commission observes that, to the extent that an urban growth boundary is intended to constrain development, it is *inevitable* that it will have some effect on land prices. For this not to be so, people would need to be indifferent to housing type and location, and the supply of dwellings would need to be just as readily expanded from established urban areas. Moreover, from the development industry’s perspective, delineation of such a boundary reduces the risk of investing in the designated areas and signals that services are to be made available that will enhance the value of the land. As the Planning Institute of Australia (PIA) (sub. 163) noted, the differential impact of such arrangements on the prices of raw land within and outside urban boundaries has been well documented for the Green Belts in Southern England.

Moreover, while a nominal stock of some 15 years' supply of land available for development accords with the lead times regarded as necessary to avoid shortages, the actual supply of construction-ready lots can still fall short as a result of delays in local government re-zoning, or the unavailability of necessary major infrastructure. Making new land available requires coordination between state governments, local governments and utilities. Wyndham Council observed:

> In growth areas in particular, infrastructure constraints may severely constrain land release. In Wyndham, for example:
>
> - Water supply constraints have retarded industrial development in Truganina, and until recently, residential development at Wyndham Vale; and
> - Arterial road constraints are currently retarding residential development south of Leakes Road, in Tarneit and Truganina, and threaten to do so in Point Cook. (sub. 210, p. 13)

Towards better processes

Economic efficiency requires that the conversion of non-residential land to residential (or from one kind of residential use to another) occurs only when the extra value, aggregated across all those affected, exceeds the cost of conversion; and when that cost is minimised. However, economic efficiency is not the only criterion against which to judge the relevant processes — fairness must also be considered. A practical difficulty, therefore, when designing decision-making processes, is that changes to land use have many effects, on many different interests, with these effects difficult to measure objectively.

While circumstances vary across jurisdictions, long lead times are inherent to the process of converting greenfield land into construction-ready lots. In the Commission's view, these long-term land release processes cannot be calibrated to meet general surges in demand, such as most Australian cities have experienced since the mid-1990s.

Historically, fringe expansion has accounted for only a fraction of housing turnover and cannot cater for much of the demand for upgraded or better positioned housing. Even so, addressing any bottlenecks in the conversion of greenfields land would moderate growth in prices at the urban fringe to the benefit of first (and other) home buyers and this would have some flow-on effects on the general housing market over time.

Some inquiry participants were critical of existing processes and argued in favour of more formalised strategic planning, akin to the *Melbourne 2030* process. However, as noted, the *outcomes* of that process were not always viewed favourably.

Strategic planning and controls on development can be justified on the basis that some of the social costs and benefits of locational decisions, such as environmental impacts, are not reflected in prices faced by participants in the market. A problem with relying on supply-side controls though is that they may not account adequately for community preferences. One benefit of a progressive shift to 'user pays' systems for infrastructure services (chapter 7), is that it should reduce the extent to which prescription is necessary to determine where new development can occur. However, there is little evidence that, in practice, the degree of prescription has diminished.

In the Commission's view, governments should test publicly the assumptions and tradeoffs implicit in their decisions about urban development when formalising their plans. The apparent lack of publicly available information in some cities suggests that such processes are not always adequate.

Relevant considerations in the development of such plans include, in the case of urban consolidation policies, the scope for savings in infrastructure costs, and assessment of the effects on the environment and neighbourhood amenity. For example, while in most cities there is generally some spare capacity in economic infrastructure, this can vary markedly according to location and between different forms of infrastructure, as noted in submissions by the WA Government (sub. 190) and the SA Government (sub. DR295).

RECOMMENDATION 6.1

All state and territory governments should have long-term land release strategies that are based on extensive public scrutiny of projections and key assumptions. The tradeoffs between greenfield development and urban consolidation should be a particular focus of such processes.

A range of inquiry participants favoured a nationally coordinated approach to urban development planning. In particular, the PCA (sub. 194) proposed that the Council of Australian Governments (CoAG) develop a 'national strategic planning framework' that would 'establish urban, regional and rural development plans across the nation' over a 30 year horizon, with a focus on infrastructure needs and including 'mirror' strategies for land release and zoning.

Others saw a need to 'reinvent' the Indicative Planning Council (IPC) to provide a national perspective on land supply and demand forecasting.

In the Discussion Draft, the Commission indicated its preliminary view that a national strategic planning framework would have difficulty accommodating urban and regional diversity and produce few tangible benefits. It expressed similar reservations about proposals to re-establish the IPC.

The Commission sought further input from participants on the potential role and contribution of such arrangements. Little elaboration was forthcoming from the proponents, however, while some other participants expressed support for the Commission's position. For example, the PIA noted that it 'strongly supports greater national involvement in urban policy, but would advocate a less centralised model, based on subsidiarity principles' (sub. DR271, p. 7). The PIA called for a CoAG-endorsed 'Australian Sustainable Development Charter', involving overarching principles and national targets covering a wide range of performance standards for urban life.

While the Commission remains doubtful about the scope for, and indeed value of, nationally coordinated planning, it sees considerable benefits arising from processes and forums that promote comparisons and learning across jurisdictions about issues in common. However, it is unclear that existing institutional vehicles, such as the Local Government and Planning Ministers, and the Housing Ministers councils, cannot adequately discharge such a role.

On the question of whether better data could be made available to government and market participants on prospective trends in population and household formation, the Commission is similarly unconvinced that a further national initiative is required to supplement what is already done by the Australian Bureau of Statistics and the Department of Immigration and Multicultural Affairs. However, there may be scope to improve the information base by recategorising migrants and visitors to better reflect their likely impact on housing demand (chapter 4).

One specific alleged deficiency in information about potential land supply raised by the HIA and PCA relates to land owned by government. Those organisations proposed that an audit be undertaken of Australian, state and local government property that could be surplus to requirements and made available for residential development.

The Commission sought responses from governments on this matter. These indicated that, both at the Commonwealth level and among a number of state governments, reviews of this kind have been taking place. For example, the SA Government said there are strong financial incentives to identify and dispose of such land. It has in place a centralised system for assembling surplus land and undertaking, prior to disposal, a strategic assessment of future use (sub. DR295, p. 5). The PIA similarly noted that there are strong incentives for governments to release unused land.

6.3 Planning approvals

From a price or affordability perspective, a critical consideration in decisions about constraints on the rate of expansion of fringe development is the scope for 'infill' development to meet the ongoing growth in demand. As in the case of conversion of greenfield land to construction-ready lots, local governments play a key role in the re-zoning or approvals processes that enable higher-density redevelopment to take place. The effectiveness of this stage of the supply chain is examined in this section.

The planning approval process is critical to the timely and appropriate expansion and reshaping of cities. However, the overwhelming view put to this inquiry by those involved in seeking planning approvals is that the processes are deficient and have become increasingly so — and that this has played a role in the recent escalation in house prices.

State and territory governments directly influence the land that is potentially available for the construction of dwellings. However, decisions about what development is permissible and where, within these parameters, are generally made by local governments. It is in this context that some state governments have initiated reviews or are making changes to planning approval processes in recognition that things can be done better at a local level.

As noted, in the present national inquiry, it has not been possible for the Commission to get to the bottom of all the various concerns in different jurisdictions. The approach taken, therefore, has been to identify some common issues and avenues that would offer the prospect of improvement in all jurisdictions. Clearly, doing better in this area could prove critical to governments achieving their urban consolidation goals without unduly reducing housing affordability.

The processes in brief

The need for planning controls in themselves is generally not in dispute. Such controls are intended to meet legitimate public and private interests, including environmental amenity and the wellbeing of communities, and to enable coordinated provision of economic and social infrastructure.

Local government, under state delegation, is generally both the planning authority (for local plans) and the planning approval consent authority for its municipal district. Local governments have discretion about how development assessments are conducted and legislative requirements are interpreted. Hence, though it is possible to provide a stylised summary of the approval process (see box 6.3), there are many local differences in procedures and requirements (see below).

The decisions that councils make as the principal consent authority are constrained by state legislation and planning policies. For example, multi-dwelling and subdivision development in Victoria requires a planning permit to be issued, with the application assessed against provisions outlined by the state government in *Rescode* — a package of provisions for residential development, including character and heritage overlays. Also, there are statutory time limits in most states and territories both for councils to make determinations, and for referral authorities to provide input into applications. These vary across jurisdictions, but typically are in the range of 30 to 60 working days for a determination (with a wider range for referral decisions).

Box 6.3 **A typical planning approval process**

- *Prelodgement* — During this stage, applicants are informed of the types of development permitted, what development controls may apply and the informational requirements of the approval process. Discussions may also be held between the applicant and residents from neighbouring properties or residents of the wider local area.
- *Submission to council or consenting authority* — Submissions are often required to be accompanied by specific information (such as environmental impact reports).
- *Public notification and objection resolution* — Applications for particular types of development are typically required under legislation to be advertised. There may be further advertising requirements in local government rules. If there are objections from third parties, a resolution process may take place before the assessment proceeds.
- *Assessment* — The consenting authority assesses the merit of the application against the provisions or rules stipulated in relevant planning instruments.
- *Determination* — The consenting authority decides whether or not to grant the approval and, if so, what if any conditions are attached to the approval.
- *Appeal* — An applicant who is dissatisfied with the determination generally has a right to appeal the decision in a court of law. There may also be review mechanisms that applicants can pursue as an alternative to litigation.

If developers or ‘objectors’ are not satisfied with a determination, they can generally seek a review. For example, under section 82A of the NSW *Environment Planning and Assessment Act 1979*, local councils are able to review determinations. Alternatively, parties can seek to appeal a decision in the Land and Environment Court. In other jurisdictions, appeals may be heard by administrative tribunals (for example, the Victorian Civil and Administrative Tribunal (VCAT) in Victoria and the Administrative Appeals Tribunal in the ACT).

Perceived problems

Planning approvals require due process and this inevitably takes time, as the prescribed statutory limits suggest. However, many inquiry participants claimed that delays have increased considerably in recent years, as have the associated compliance costs and the uncertainty about outcomes. The views of one such participant — Langford-Jones Homes (sub. 126) — are reported in box 6.4. The HIA (sub. DR250) cited the case of Masterton Homes, which in a recent submission to the NSW Minister for Infrastructure, Planning and Natural Resources, had indicated that approval times for its projects had increased from 27 days prior to 1998 to 84 days in 2002.

Are delays getting worse?

In its submission to this inquiry, the Royal Australian Institute of Architects (RAIA) (sub. 148) reported the results of a recent survey of its members, which suggested that processing times for both single (new) homes and medium-density developments have increased in nearly all states.

The survey revealed (in both NSW and Victoria) that the average processing time for a new house was now around seven months, compared with four to five months in 2000. The reported increase in delays was even greater for medium-density housing projects, with application times having risen from six months in both states to nine months in NSW and 11 months in Victoria in 2003. As shown in figure 6.5, while estimated processing times in the survey increased elsewhere, they remain much lower.

It has been difficult to reconcile these estimates against data available from official sources. For example, information reported by NSW municipalities, while showing wide variation between jurisdictions in the time taken to determine development applications (from two to 117 working days), does not reveal any increase in delays at the aggregate level (see figure 6.6), though it is notable that they are around 50 per cent longer in inner-metropolitan areas than at the fringe.

Box 6.4 Building a house in South Gippsland: one company's experience

Under the *Planning and Environment Regulations 1998*, all councils in Victoria are required to process a planning application in 60 days. This timeframe may be extended by a further 28 days if a council needs to forward the application to a referral authority.

But even with these requirements in place, Langford-Jones Homes claimed that in the South Gippsland Shire it can take eight months for the council to process a planning application:

> Not withstanding there are referral periods within the process whereby external departments and authorities are required to assess the application, 8 months still appears to be an extraordinary amount of time to wait for a single house to be approved. (sub 126, p. 2)

According to the company, such delays in the planning approval process can add $6000 to $7000 to the cost of building a house in the South Gippsland Shire (trans., p. 298).

It was noted that all builders in the South Gippsland Shire need a planning permit to comply with a standard set of regulatory design requirements for a single dwelling — the installation of a colorbond roof, a sewerage treatment plant, a water tank and pump for fire protection, vegetation clearance within two metres of where the dwelling will be located, and a requirement that building products be finished in muted tones. Langford-Jones Homes argued that these six standard requirements should be covered only by a building permit, thereby reducing considerably the costs of planning delays.

Langford-Jones Homes also argued that 'overlays' should be dealt with at the subdivision stage, claiming that this would eliminate the necessity for new buildings to be subject to a full planning assessment.

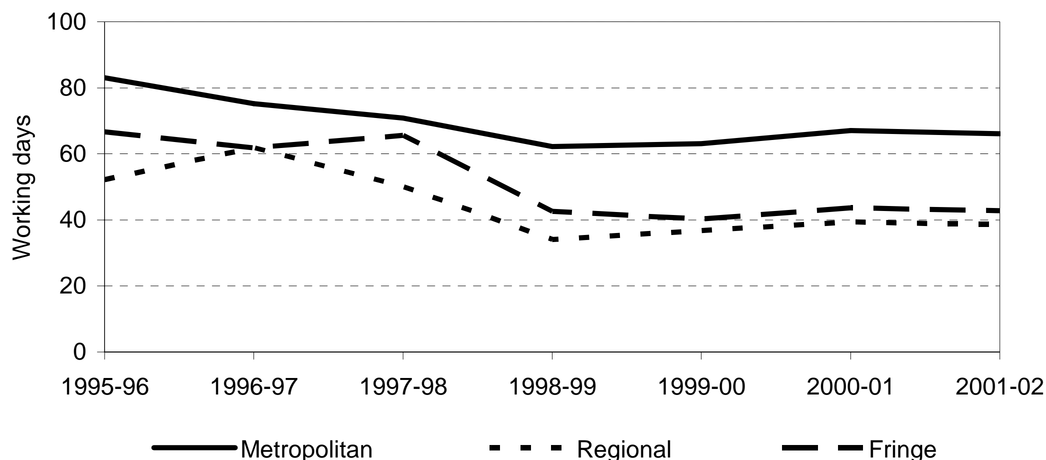
Sources: Sub 126; trans., pp. 298-305.

A further source of information comes from a recent survey commissioned by the Local Government Association and Shires Association of NSW (sub. DR323), involving development applications lodged at 56 councils over a four week period in 2003. The survey found that nearly two-thirds of development applications were determined within the 40 to 60 working day limits, with the median time ranging from 29 working days for 'simple single dwellings' to 69 working days for 'integrated' development applications where approval is required from more than one authority. These outcomes seem broadly consistent with the 'official' data collections summarised in figure 6.6.

Figure 6.5 **Architects' assessment of planning approval delays (medium-density housing)**

Data source: RAIA (2003).

Figure 6.6 **Mean time for determining development applications, NSW**



Note. The processing time for an application starts when the application is lodged and ends at the date of the notice of determination. From 1999-00, councils have been able to deduct the days the assessment clock was stopped because of requests for additional information.

Data source: DLG (NSW) (2003).

It is possible that the introduction of the 'stop-the-clock' counting rule has masked an increase in the time taken to process applications. Since 1999-00, councils have been allowed to 'stop the clock' when additional information is being sought. However, it seems improbable that this could explain the large difference between the RAIA survey and data collected from municipalities, even converting council working days into total lapsed time.

Apart from methodological issues, another possible explanation for the difference between the trends in municipal statistics and the RAIA survey results may be in the time taken for prelodgement procedures — which are not covered by data from the Department of Local Government. Anecdotal reports suggest that there has been an increase in processing times at this stage, but how significant it has been is unclear.

In considering the possible reasons for any increase in delays in the last few years, the surge in demand documented in earlier chapters is clearly relevant. The PIA noted that 'Complaints about planning delays seem to be cyclical … Any system has trouble coping with peaks and troughs' (sub. 163, pp. 9-10).

Nonetheless some systemic issues may be compounding the cyclical pressures. The key ones raised by participants are considered next.

Skill shortages

Reports of a decline in the capacity of many municipalities to process applications efficiently have come from a variety of sources. For example:

- The RAIA's member survey provided evidence of under-resourcing and lack of experience or training of personnel.
- The PIA noted (sub. 163, p. 11) that heads of planning agencies had been sufficiently concerned to commission a national inquiry into planning education and employment.
- A 2001 profile of local government planners in Victoria found that 44 per cent of council planners had less than two years' experience (DoI 2001).
- A Victorian judge noted that an increase in the number of matters subject to planning approval, and in the discretion required of planners, have not been matched by an increase in staff:

> These days it is increasingly common for citizens to need a permit for such things as painting of dwellings, lopping of trees, extensions to dwellings and the like. But the growth in discretionary decisions has not been matched by a growth in the number of planning officers to consider them. (Morris 2003, pp. 1–2)

In discussions with the Commission, senior industry representatives said that they have been obliged to recruit skilled, experienced people to help their companies navigate more extensive and complex approval requirements. Many of those recruits have been attracted or diverted from council employment.

Local government associations acknowledged the problem in submissions and at the public hearings. For example the Local Government Association of Queensland (LGAQ) said:

> The lack of experienced staff has been recognised as a major focus for LGAQ in 2004. It is anticipated that a number of policy and project responses will be required to commence addressing the skills shortage in Queensland Local Government. (sub. DR246, p. 4)

The PIA (2004), in a draft report for its National Inquiry into Planning Education and Employment, stated that over the last three years, the rate of unfilled positions has been over 19 per cent. The vacancies are greatest in local government, the largest employer of planners. The problem was found to have become critical in major cities (Brisbane, Melbourne and Sydney) and has been a longstanding problem in rural and regional Australia.

The PIA is currently consulting on a number of initiatives, including:

- increasing the number of funded places at Australian universities for planners;
- including planning on the 'Migration Occupation Demand List';
- 'pooling' planning resources where shortages arise in rural and regional areas;
- improving the development assessment process by establishing assessment panels; and
- improving its accreditation processes.

The Commission sees the inquiry and the emerging policy initiatives as a positive development. However, some consideration of the role of remuneration and working conditions would also seem important. The scope for contracting out is also a key issue for councils. At the public hearings, Cr Maire Sheehan noted that Leichhardt Shire had provided the option for applications to be processed by specified private agencies for an extra fee, and that this had worked well for both the Council and the applicants. However, the 'experiment' was terminated by the State Government because of perceptions of inequity (trans., p. 163).

More complex and demanding processes

Responses to the RAIA survey indicated that, in most jurisdictions, considerably more time and effort are now needed to prepare a planning application than three years ago. Among other things, the RAIA identified the following matters that could have contributed to the additional work:

- 'unreasonable demands' for material relating to 'technically simple' jobs;
- a rise in the incidence of heritage and landscape issues;
- rigid application of planning submission requirements for 'very small' projects; and

- requirements to provide reports that ultimately prove redundant.

The HIA (sub. 177) similarly alleged that planning systems have become more 'fragmented, complex and unpredictable'. Among the issues raised by the HIA were:

- expanded coverage of planning approval requirements;
- a 'plethora' of legislation and referral agencies;
- 'layered' planning systems; and
- rigid application of development standards.

Councils also pointed to the increased number of matters to which they must now have regard, including many environmental or heritage issues that were not seen as important even 20 years ago.

Given the changes within cities and in community values, such additional requirements are inevitable. Thus the PIA argued that planning approval processes today needed to reach standards of rigour and community consultation well above what was acceptable in the past.

> To some extent, the 'relative speediness of approval process[es]' of the past — a feature often fondly recalled by industry stakeholders — was won at the expense of environmental quality and sustainability ... The community now demands much better outcomes and it is inevitable that planning approval processes will be more exhaustive and time consuming as a result. (sub. DR271, p. 3)

A question remains, however, as to whether the requirements have caused more work and delay than is warranted. The Victorian Government noted:

> There are about 150 permit triggers in planning schemes resulting in some confusion in the identification of the appropriate triggers. Many planning permit requirements in schemes exist where there is little nexus between the matter being controlled and the achievement of a planning outcome. (DSE 2003b, p. 5)

The implication is that there is likely to be scope to streamline or rationalise processes in ways that reduce transaction costs and delays without compromising legitimate environmental or heritage goals.

Objection and appeal processes

Due process requires that planning approval procedures provide scope for those adversely affected by a decision to object or appeal. How extensive or accessible those provisions should be is subjective, and involves balancing the interests of

potential new residents against the interests of incumbents, and sometimes the wider community.

Those representing applicants have been most vocal on these matters in this inquiry. They have argued that the scope for residents to block new development is excessive, causing significant delays and costs. For example, the UDIA (Victoria) (sub. 121, p. 15) claimed that the objection process is often 'frustrating and time-consuming', noting among other things that:

- objecting is free of charge and easy; and
- the basis for objection is often poorly informed.

The Victorian Government has observed that its planning legislation gives wide discretion to local councils in deciding whether or when 'material detriment' may be caused, and that 'there has been a tendency for councils to extensively notify almost all applications' (DSE 2003b, p. 17). In the context of increased 'activism' by residents in protecting their perceived rights, this has resulted in one-third of applications in the metropolitan area receiving objections.

Data for NSW and Victoria show a rise in the number of appeals since 1994 (see figure 6.7). In Victoria, 6 per cent of all permit applications were appealed to VCAT in 2002. The rise in Victoria is from a higher base, but the number of dwelling approvals has also risen strongly in Victoria since 1994 (see figure 6.4), such that the growth in appeals has been broadly in line with the increase in building activity.

In NSW, the number of appeals has grown from a lower base (see figure 6.4). However, unlike Victoria, the number of dwelling approvals has not grown, suggesting that there may have been an increase in the incidence of appeals. This may reflect the higher proportion of development activity occurring within established areas in NSW, which is where disputes are more common. Even so, the proportion of approvals appealed is lower in NSW than in Victoria.

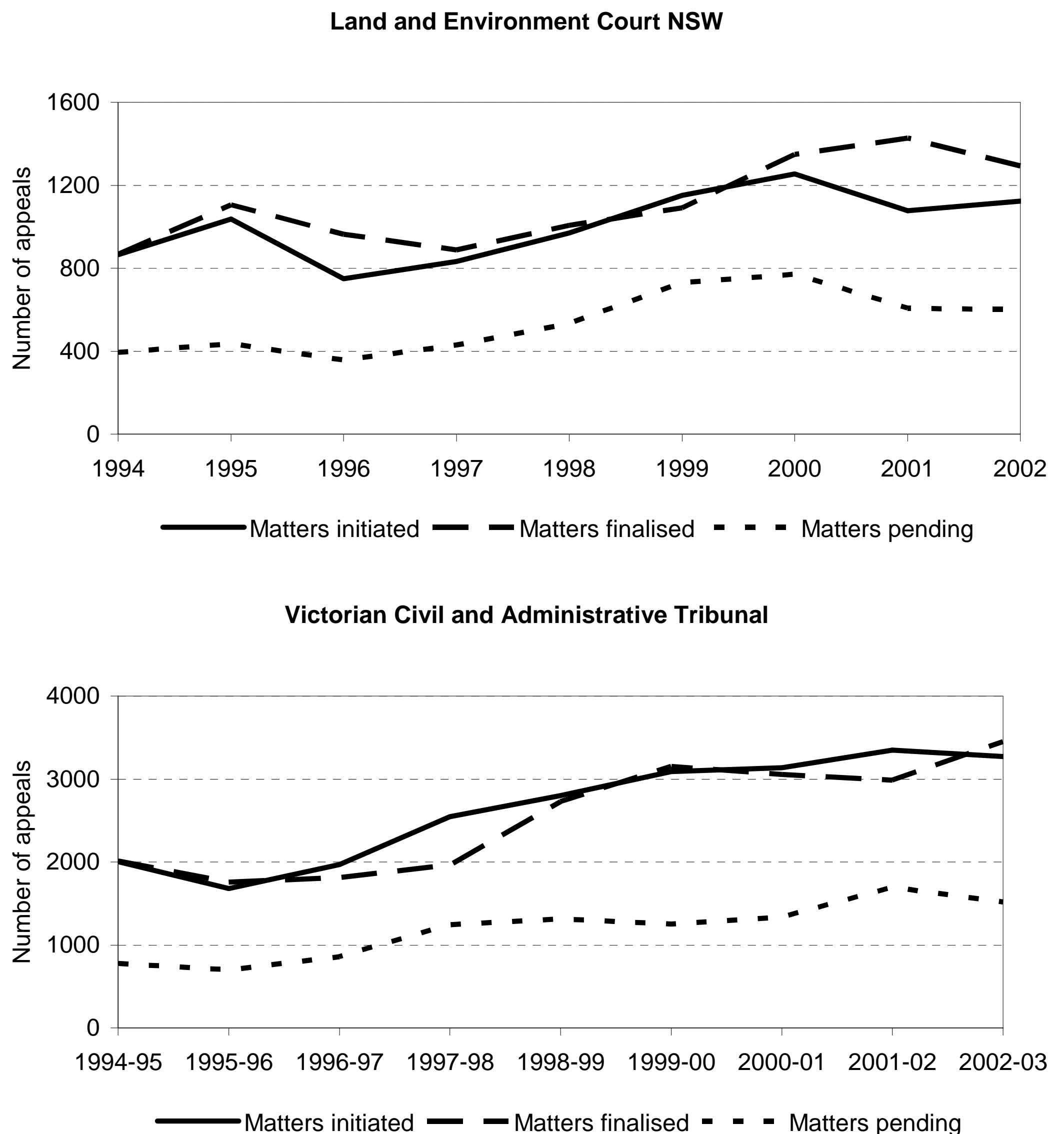
Complaints have been made that the appeals mechanism has been increasingly used to resolve planning issues that should be resolved by planning staff and approved by councils. The RAIA noted that there are examples where some architects requested that a planning application be lodged for approval with the expectation that, after waiting until the statutory processing period had expired, the planning application could be determined via appeal rather than having to face the process of dealing with a local council. The use of the appeals process in this fashion was acknowledged by the NSW Department of Local Government:

> Councils at times are reluctant to take responsibility for the determination of some matters at the local level due to their being contentious and subject to political,

factional, environmental or community pressures. Accordingly, councils abrogate their responsibilities and allow the court to make decisions. (LECWP 2001, p. 21)

Utilisation of court processes can be costly. The UDIA (Victoria) (sub. 121) noted that the time taken typically ranges from three to six months. Hence, it is important that legal remedies apply only as a last resort and not, for example, to circumvent blockages in the approval process. More broadly, it is also important that the appeals process provides for an appropriate balance between due process and the cost of delays. Some possible avenues for achieving a better balance are set out below.

Figure 6.7 **Trends in development appeals, NSW and Victoria**



Data sources: LEC (NSW) 1996-2002; VCAT, Victoria, pers. comm., 10 October 2003.

In discussions with the Commission, some industry representatives raised more fundamental questions as to whether current decision-making processes met the tests of good governance. Of particular concern was political interference in the approvals process. For example, Yarrum Equities contended:

> Local government elections are now a battleground for votes between major political parties and political pressure groups. Strategic power plays add costs to development as councillors are obliged to demonstrate public support for the interests of their constituent power base, often against the interest of, and benefit to, the wider electorate. (sub. DR251, p. 12)

It was alleged that councillors frequently intervened in development application processes in response to lobbying from local residents and that this is leading to poor decisions.

The involvement of councillors in planning policy and administration is provided for under legislation in most states. As Spiller observed:

> This opens up multiple opportunities for development capital to influence outcomes through forceful lobbying. And it also opens up multiple opportunities for sectional interests in local communities to stymie socially useful investment … In the meantime, life becomes very difficult for planners in development assessment. They are often the meat in the sandwich. (Spiller 2004, p. 2)

Ideally, political representatives who devise rules should stand back from their application in particular cases, leaving others to assess those cases against clear criteria, which have been developed through public consultation.

In practice, however, it will often prove impossible to codify policy in terms that eliminate all ambiguity about what development is acceptable. This is especially so in situations where performance standards are used to overcome some of the rigidities of highly prescriptive regulation. As the PIA observed:

> Discretion often needs to be exercised in terms of such matters as streetscape continuity, urban design, impact on social networks and infrastructure and cultural implications. (sub. DR271, p. 3)

The Local Government Association and Shires Association of NSW (sub. DR323) argued that councillors already determine staff delegations appropriate to local circumstances under statute and, as the community's elected representatives, need to 'retain control' of the planning process. The Associations argued, based on the recent survey cited above, that in reality only a small proportion (4 per cent) of development applications are determined by councillors, but that because these tend to be the most complex and controversial, they attract disproportionate attention.

Nonetheless, the PIA, while recognising the policy importance of planning decisions, considered that they are:

> ... more likely to be delivered consistently and impartially under delegation by professional planners, or panels which include professional planners and elected members, such as in the South Australian DAP [Development Assessment Panel] model. (sub. DR271, pp. 3-4)

The Commission accepts that some involvement of elected members in planning decisions is appropriate in some circumstances. However, there are still the issues of whether more effective separation can be achieved, and whether additional measures are required to ensure transparency and accountability of all decision making (see below).

Towards better processes

The Commission's brief review of the evidence and issues raised thus far, suggests that while the extent of any unwarranted increase in delays is unclear, there is likely to be scope to improve decision-making processes in ways that would enhance efficiency while maintaining the protections of due process.

Governments themselves have recognised the need to do better and some have already initiated useful reforms (see box 6.5).

Moreover, as the Australian Local Government Association noted, most states and territories are currently undertaking reviews of their planning systems and/or development assessment processes 'to improve their transparency and efficiency' (DR307, p. 11). These reviews include the NSW Regulation Review — Local Development Taskforce, the Victorian review 'Better Decisions Faster', the SA Development Assessment Panel and, at a national level, the work of the Development Assessment Forum (DAF) — comprising representatives of Australian, state, territory and local governments; the development industry and related professional associations.

The NSW Regulation Review–Local Development Taskforce (see box 6.6) and the DAF (see box 6.7) are concerned with assessment activity, appeals mechanisms and governance issues. 'Better Decisions Faster' (see box 6.8) is focussed mainly on the processing of applications.

The combination of state-based reviews and the work of the DAF at a national level provides an important opportunity for informed debate and assessment of potentially useful reforms. As noted, these reviews are better placed than this broader national inquiry to assess in detail problems in different jurisdictions and to

develop specific options for addressing them. Nevertheless, in the Commission's view, the following four areas deserve close attention as the proposals and direction for reform identified in such reviews are carried forward.

Box 6.5 **Examples of reforms to planning approvals**

- *Prelodgement certification* — Initiatives in this area have been aimed at speeding up the approval process through the formalisation of the prelodgement stage. For example, in Victoria, procedures have been developed aimed at ensuring that applicants submit applications that meet the information requirements of the approval process.
- *Fast-tracking approvals* — There have been various changes made to speed up the approval process on major projects. However, this may involve some diminution of the rights of third parties to object to planning decisions. For example, the SA Minister can define a development as a 'major development' (development of major social, economic or environmental significance) in which rights such as merit appeals, judicial review and civil enforcement are removed.
- *Integrated approvals process* — The intention is to reduce the number of agencies that applicants have to deal with to gain approval. For example, the NSW Government has introduced a single point of contact for developers to obtain the separate applications required by different referral or approval bodies.
- *Outsourcing assessments* — A number of councils, including Leichhardt, Woollahra and North Sydney, have trialled private sector involvement in planning approval assessments on a fee-for-service basis in order to speed up the process and overcome skill shortages.
- *Alternative dispute resolution mechanisms* — Such changes have mainly been aimed at reducing the number and duration of appeals by resolving disputes early in the planning approval process (usually the prelodgement stage). Examples include the Independent Hearing and Assessment Panel (Liverpool City Council 1997, Fairfield City Council 1999) and the introduction of facilitation committees (Gosford City Council).
- *Speeding up court hearings* — Before an appeal proceeds to a hearing in the SA Environment, Resources and Development Court it is referred to a compulsory conference. The conference, which is generally chaired by a Commissioner of the Court, provides an opportunity for all parties involved to express their views and resolve differences in relation to the development proposal without the need to invoke formal court proceedings. In 2003, around 47 per cent of applicant appeals were resolved by compulsory conference, compared with 35 per cent in 2000.

RECOMMENDATION 6.2

State and local governments need to give priority to the scope to:

- ***achieve greater separation of policy making and administration;***
- ***streamline permit approval processes to enable minor or uncontentious developments to by-pass unnecessary informational or consultative requirements;***
- ***improve or expand 'as of right' development provisions, without detracting unduly from the property rights of existing residents; and***
- ***reduce delays in appeals while maintaining the protections of due process.***

Box 6.6 **Local development assessment review in NSW**

In October 2003, the Regulation Review–Local Development Taskforce reported the outcome of its review into the local development approval process, making over 60 recommendations to improve the speed and quality of those processes. These included:

- Creating a common set of *standards* for streetscapes, setbacks, open spaces, privacy and sunlight protection, with the aim of removing up to 70 per cent of development applications for single houses, alterations and carports from the coverage of councils' development assessment.
- Establishing mechanisms that speed up *approvals* for the majority of houses with a safety net process to deal with the more complicated proposals.
- Establishing *best practice guidelines* for councils to write clear standards and development policy that make it easier to prepare, review and assess development applications.
- Reforming *governance* to achieve better strategic planning and policy making by councillors, reducing the level of councillor involvement in development application assessment and providing greater opportunities for independent decision making by technical experts.
- Improving the *certification* process by removing council responsibility to audit certification, clarifying the roles and responsibilities of certifiers and achieving more stringent levels of government accreditation, auditing and regulation.
- Allowing *fast tracking* of development approvals for a fee.

Source: DPNIR (2003b).

Box 6.7 **The Development Assessment Forum's 'leading practices'**

1 Separation of roles

It is recommended that elected politicians take responsibility for the development of planning policies and that independent bodies (such as panels) be responsible for assessing applications against these policies.

2 Technically excellent assessment criteria

The community values and policy objectives set by governments should be codified as objective tests and rules.

3 A single point of assessment

Decisions on development applications, based on technically excellent criteria are best integrated by a single entity. Relevant government agencies, with a defined statutory role, will also provide their advice. However, this advice must conform to technically excellent assessment criteria.

4 Independent and expert assessment

It is proposed that panels be established at local or regional level to assess projects not determined by professional staff, and to review staff decisions. It is anticipated Ministers may wish to retain call-in powers based on criteria prescribed by statute.

5 Appeals as a second assessment

Discretionary decisions should be reviewable. In a merit appeal, applications should be assessed against exactly the same criteria by a more senior independent expert body.

6 Defined third party involvement

Under the proposed model, a development assessment is made against technical criteria that enshrine policy developed after community consultation. Unless an error in administration occurs, third parties are encouraged to advocate change to the policy driven criteria.

7 Private sector involvement

In specified circumstances it is recommended that private sector experts provide advice that attests to compliance with technically excellent criteria. In most cases, this advice would be considered by the assessing authority (whether government officer, panel or commission).

8 Stream assessment into tracks

Early in the development assessment cycle, a project application should be streamed into a specific assessment track. Each track comprises a specific set of decision-making steps relevant to the project's complexity and impact on the built and natural environments.

9 Built-in improvement mechanisms

Formal feedback loops with the development assessment are proposed. This approach would incorporate lessons learned by key stakeholders into overall planning policy, technical assessment criteria and the operation of the development assessment system.

Source: DAF (2004).

Box 6.8 **'Better Decisions Faster': Victoria's planning system review**

The objective of the Victorian review is to produce 'substantial improvements to the efficiency and effectiveness of the 'process' component of the planning system', including in timeliness and decision making, reducing unnecessary complexity and informational requirements, and clarifying roles and responsibilities.

A recent discussion paper sets out a range of options relating to each stage of the permit process, including:

- encouraging external prelodgement certification;
- imposing time limits on requests for further information;
- imposing administration fees on objectors;
- increasing 'deemed to comply' provisions;
- extending self-assessment opportunities;
- streamlining the permit process;
- providing guidelines to help inform VCAT reviews; and
- undertaking regular process auditing.

Source: DSE (2003b).

As responses from participants to the Discussion Draft illustrate, there are no single or uncontentious solutions in any of these areas. In each of them, a core issue is the extent to which clear rules, with broad community support, can be established. Some have argued that lack of clarity in assessment criteria has been a major cause of dispute, as well as being a constraint on greater delegation or self-assessment.

In the Commission's view, it is critical that the clarity issue be addressed, as recognised in the DAF's 'leading practices' (box 6.7). That said, it is inevitable that subjective criteria and scope for discretion will be needed in some areas. Indeed, excessive prescription in the pursuit of objective standards would bring its own costs.

To the extent that necessary judgments cannot all be technical in nature, a role for councillors seems inevitable. However, as noted by the PIA, this could be accommodated in ways that provided more formal separation than currently exists, such as through ongoing (minority) participation of councillors in expert assessment panels (South Australia's Development Assessment Panel model) and/or the development of strict guidelines for circumstances in which councils can review delegated assessments. Such structures could in themselves encourage councils to place more emphasis on developing sound assessment criteria. Similar requirements should also apply to ministerial call-in powers.

The extent to which processes can be streamlined, or include 'as of right' provisions (as in DAF's six 'assessment tracks') is especially contingent on having clear and accepted rules. Local government associations noted that some initiatives had already been made in these areas, but raised concerns about how beneficial they have been (for example, in areas such as private certification). Also, 'as of right' provisions are likely to be more readily applicable to single dwelling than multi-unit construction, and for houses in new subdivisions at the fringe than for redevelopment projects in established areas.

Under the DAF proposal, third parties are encouraged to advocate change to the criteria by denying them a right of appeal. Although third-party appeals may be a source of delay and frustration to those seeking approval, in the Commission's view, ruling out third party appeals would seem to place too high an expectation on achieving clarity and objectivity in the rules.

There would seem to be scope to reduce costly appeals through procedures such as compulsory conferences and mediation, or the provision of second 'expert' assessments prior to any access to courts or tribunals. Such 'low level' appeal mechanisms appear promising as a way forward in what will always be a difficult and contentious area.

Concluding remarks

In the Commission's judgment, given the small size of net additions to housing in any year relative to the size of the stock, improvements to land release or planning approval procedures, while desirable, could not have greatly alleviated the price pressures of the past few years. Nonetheless, removing unnecessary impediments on the supply side is clearly important to affordability in the long run, particularly in the context of the focus on planning to contain 'urban sprawl'. A question remains though as to the feasibility and desirability of achieving urban consolidation on the scale contemplated in the current planning of some governments.

In an area as complex and contentious as land-use planning and development, there will inevitably be an element of 'experiment' in any initiatives adopted to improve regulatory processes. This underlines the importance of not only subjecting new proposals to adequate testing and scrutiny, but also conducting periodic reviews to assess the performance of those that are implemented. It also cautions against seeking to impose uniform national approaches before likely outcomes have been properly assessed. This in turn highlights the importance of having mechanisms to enable best practice to be communicated across jurisdictions on an ongoing basis.

7 Are infrastructure charges excessive?

Findings

- While infrastructure charges, like other costs of bringing housing to the market, have increased over time, they cannot explain the surge in house prices since the mid-1990s.
- The claimed cost savings and improvements in affordability from reducing reliance on developer charges for infrastructure appear overstated:
  - Most categories of charges are both justified and desirable on efficiency/equity grounds.
  - Housing affordability should not be significantly affected by greater reliance on upfront charging as opposed to charging over time.
  - Developer charges for those items of social or economic infrastructure that provide benefits in common across the wider community have generally been relatively small — though such infrastructure should desirably be funded out of general revenue sources.
- Even if the cost of providing infrastructure to new developments were shifted onto the wider community, housing affordability might not be greatly enhanced.
- Developer charges and contributions for infrastructure should be:
  - *necessary*, with the need for the infrastructure concerned clearly demonstrated;
  - *efficient*, justified on a whole-of-life cost basis; consistent with maintaining financial disciplines on service providers by precluding over-recovery of costs; and
  - *equitable*, with a clear nexus between benefits and costs, and only implemented after industry and public input.
- Those imposing developer contributions and charges should:
  - follow guidelines based on these principles and be subject to independent regulatory scrutiny;
  - provide for ‘out of sequence’ development if developers are prepared to meet the cost consequences;
  - be open to proposals for alternative infrastructure arrangements that meet the needs of the households concerned;
  - allow appeals on the amounts charged, or their coverage; and
  - be accountable for how money raised from charges is spent.

Australians today expect to have a range of basic urban services when they purchase a house. These include sewerage, drainage, water, electricity, roads, public transport and facilities such as parks and libraries — collectively described as infrastructure. Planning approvals for construction are not normally granted unless most of these services are available.

Historically, some of this infrastructure was put in place only after new housing had been established. The infrastructure would be paid for either through general rates or tax revenue, or by charging the households in certain districts a special rating levy to cover the costs of the infrastructure installed for their benefit — for example, sewerage, curbing and guttering. The initial capital outlays would be paid for out of capital works funding or borrowings, or from infrastructure utilities' retained earnings.

For at least the last 20 years, however, the trend has been to install infrastructure from the outset, with more of the initial funding burden shifted onto developers through upfront charges. Developers have in turn sought to pass the charges on in higher prices for serviced lots and house and land packages. These changes have been driven by a combination of demands from households for earlier access to 'necessary' infrastructure and constraints on government finances that have led to pressure to reduce outlays on housing-related infrastructure.

The shift in infrastructure charging has always been contentious, in part because of concerns about the implications for housing affordability — as well as efficiency and equity — and no doubt in part because of developers' concerns about the implications for housing demand and their returns.

In this inquiry, concerns have been raised about infrastructure financing, the expanding coverage of cost recovery, the time over which costs are recovered, and the structure of the charges.

The Housing Industry Association (HIA), the Property Council of Australia (PCA) and others claim that infrastructure charges are too high and that they are being levied on an inappropriate basis. They have highlighted the potential to reduce charges, or at least reallocate the infrastructure cost burden away from new development and onto a broader group of ratepayers. For example, the HIA has suggested that such changes could reduce the costs for a typical new house and land package in a Sydney greenfield development by about $30 000 plus tax (sub. 177, p. 97).

These contentions arise against the backdrop of moves by governments to constrain the outward expansion of cities, partly as a result of rising infrastructure costs at the urban fringe (chapter 6). This raises a potential dilemma for the industry, as the

move to developer charges has arguably enabled more rapid development at the fringe than had infrastructure supply been dependent on borrowing by government agencies. Moreover, as the HIA's submission (sub. 177) has acknowledged, a properly constituted 'user pays' system promotes efficient location decisions by home buyers, reducing the need for regulatory constraints directed at the same objective.

Taking account of these perspectives, the Commission has focused on three key issues central to the efficient and equitable provision of, and charging for, housing-related infrastructure:

- Who should pay for what quality and quantity of infrastructure?
- When should they pay?
- What are the implications for house prices and affordability?

The scope for the Commission to go beyond these key high level issues and to assess actual practice has been constrained by time, the limited information available, and diversity of practice across jurisdictions. Nonetheless, this high level assessment has helped to identify some deficiencies in current practices and potential ways to improve on outcomes.

7.1 Types of infrastructure and magnitude of costs

There are two main types of infrastructure — economic and social — for which developers can incur charges:

- *economic* infrastructure provides services such as water, sewerage, drainage, electricity, gas, telecommunications, public transport and roads; and
- *social* (or community) infrastructure is used to provide a range of community and recreational services; for example, libraries, community centres, sports grounds and parks.

It is useful to separate economic infrastructure into two further categories — '*major*' and '*basic*'. These categories are distinguished by the extent to which the infrastructure can serve other developments, with 'major' infrastructure generally servicing a number of subdivisions and 'basic' infrastructure mainly providing services to a particular subdivision (see box 7.1). Major infrastructure is generally, but not always, 'external' to a development. Basic infrastructure is located 'on-site' within a development.

Box 7.1 **Types of infrastructure**

- *Economic infrastructure* — traditional infrastructure such as water, sewerage, drainage, electricity, gas, telecommunications, public transport and roads.
  - *Major (shared) economic infrastructure* — infrastructure that services a number of land subdivisions. Examples include trunk water, sewerage and drainage, gas, electricity and telecommunications, urban rail services, major roads and airports.
  - *Basic economic infrastructure* — infrastructure within a subdivision, in most cases connecting each lot to major infrastructure, (for example, roads, water, sewerage, gas and electricity connections). Basic infrastructure is sometimes referred to as private infrastructure, because the benefits accrue overwhelmingly to the residents of the particular subdivision.
- *Social (or community) infrastructure* — infrastructure used in the provision of community services. It can primarily be for the use of residents within a subdivision (for example, parks), or it can service a whole range of subdivisions (for example, a library or a sports ground).

Government and private utilities are normally responsible for providing major economic infrastructure services. The infrastructure concerned may be constructed by the council or utility, or alternatively by the developer, who must hand it back as a 'contributed' asset. With the exception of main roads departments and public transport authorities, government utilities are now expected to operate commercially and recover their costs.

Basic economic infrastructure is generally constructed by the developer and handed over to the relevant authority as a contributed asset. (In some small developments, the developer will make a contribution to the local council and utilities as reimbursement for infrastructure to be provided). Where developers construct the infrastructure, they need to meet standards set by the relevant utility or authority.

Social infrastructure is often provided outside the area of a development. It is sometimes provided by a developer directly, but more often through payments to the local council. If it is to be provided within a development, the developer can be required to donate the land needed for it (for example, for a park).

As noted in chapter 6, there is a link between government land release and infrastructure provision. When land is zoned for residential development, it creates the expectation that major infrastructure will be provided to allow the land to be serviced. The lead times required for infrastructure planning and provision at the extremities of the urban fringe are considerably longer than for servicing infill lots when the major infrastructure is already in place or available nearby.

What is the magnitude of the charges?

The costs of infrastructure provision are substantial. For example, in 2002-03, capital expenditure on new water, sewerage and drainage infrastructure in Sydney alone amounted to around $185 million, of which $165 million was contributed by developers. It can cost $3 million per lane kilometre to replace roads and $14 million per kilometre to replace double track rail. Water and sewerage pipelines can cost about $300 per metre.

The level of infrastructure charges and contributions varies among jurisdictions. It is generally acknowledged that the imposts in Sydney are more extensive and typically higher than in other cities. However, getting comparable information is difficult.

For illustrative purposes, the Commission obtained data for two municipalities — Penrith in Sydney and Wyndham in Melbourne (see table 7.1). The Commission's case studies suggest that differences between Sydney and Melbourne in the total cost of a house and land package mainly relate to the non-dwelling components. Land acquisition, infrastructure charges and fees are all higher in Penrith than in Wyndham, supporting claims that land-related costs account for a relatively high proportion of housing costs in Sydney. (The tax and margins components are also higher in Sydney; however, this is in mainly a result of the higher cost base.)

In regard to infrastructure, the case studies:

- confirm that infrastructure costs are a substantial component of development and construction costs;
- show that charges for both economic and social infrastructure are substantially higher in Penrith than in Wyndham — this is partly because the value of land contributed for open space and roads is twice as high in Penrith; and
- support the contention that infrastructure costs generally make up a higher proportion of the total cost of a house and land package in Sydney (15 per cent in Penrith) than in Melbourne (11 per cent in Wyndham) — though this appears to be attributable to contributions for major infrastructure not being required for the Wyndham site, which is not necessarily typical of greenfield areas.

However, given variations in infrastructure charges within cities, it is difficult to draw strong conclusions about differences between Sydney and Melbourne from individual case studies. For example, case study data supplied by the HIA, comprising averages for developments in four of Sydney's fringe suburbs, indicate significantly lower overall infrastructure charges (excluding the $15 000 transport levy) than in Penrith with lower total charges for economic infrastructure outweighing higher charges for social infrastructure (see table 7.2).

Table 7.1 **Case studies of developer charges and other costs, Sydney (Penrith) and Melbourne (Wyndham), 2003**

Cost	*Penrith*		*Wyndham*	
	(dollars)	*(per cent)*	*(dollars)*	*(per cent)*
Land[a]	92 522	21.5	42 436	14.6
Economic infrastructure charges[b]	61 818	14.3	31 482	10.8
Social infrastructure charges[c]	2 737	0.6	450	0.2
Planning and building fees	4 820	1.1	1 073	0.4
Dwellings[d]	155 500	36.1	139 000	47.7
Margins[e]	60 916	14.1	45 964	15.8
Tax[f]	52 762	12.2	30 942	10.6
Total	431 076	100.0	291 347	100.0

[a] This item comprises various land acquisition costs, including raw land purchase — $62 745 per lot in Penrith and $29 598 per lot in Wyndham. [b] Economic infrastructure charges in Penrith comprise roads, drainage, water, sewerage, electricity and telecommunications (including $6000 for major infrastructure). It also includes that portion of the section 94 contributions in NSW applying to economic infrastructure. For Wyndham, the charges cover similar items of economic infrastructure, excluding telecommunications and major infrastructure. [c] Social infrastructure costs for Penrith include that portion of section 94 charges that relate to community infrastructure. Social infrastructure for Wyndham is funded by the Community Infrastructure Levy applicable in Victoria – previously capped at $450. [d] Assumed dwelling size is 220 square metres. [e] Estimated developer plus builder margins. The developer margin used for Penrith is a gross margin ex GST of 16 per cent of the expected selling price of land. The builder margin for Penrith was based on 15 per cent of the value of the dwelling package. The developer margin used for Wyndham is a gross margin ex GST of 17 per cent of the expected selling price of land. The builder margin for Wyndham was based on 20 per cent of the value of the dwelling. [f] Tax, includes GST, state land tax and stamp duty.

Sources: Estimates based on HIA (2003); Penrith City Council; Wyndham City Council; Henley Properties Group, Victoria, pers. comm., 3 December 2003.

Charges for what the HIA has termed 'social' infrastructure have been of special concern to industry, particularly in Sydney. However, the HIA case study and (especially) the Commission's case study for Penrith indicate that, as commonly defined, social infrastructure charges still comprise a relatively small proportion of total developer charges. In responding to the same conclusions in the Discussion Draft, the HIA clarified that its definition of social (or 'community') infrastructure also included major or shared economic infrastructure. But even charges for this infrastructure seem to be dominated by charges for infrastructure specific to individual developments. In the Commission's Penrith case study, they amount to less than $9000 out of total developer charges of nearly $65 000, or only two per cent of the house price. In the HIA case study, such charges (excluding the $15 000 transport levy in two of the four development areas) amount to $14 092 out of $35 917 in total developer charges.

There is limited information on how infrastructure charges have moved over time. A recent report by ACIL Consulting (2002) indicates that in those parts of Melbourne where detailed data are available, charges rose by around 40 per cent in real terms over the period 1992 to 2002. However, ACIL went on to estimate that,

as a proportion of the net selling price of a construction-ready lot, the value of these charges fell from to 25 to 15 per cent. Indeed, ACIL estimates that over this same ten-year period, government taxes and charges (including those for economic and social infrastructure) fell in all the areas surveyed except in Adelaide and Brisbane.

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

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

Note. Includes developments in Blacktown, Baulkham Hills, Liverpool and Pittwater (for Warriewood). [a] Major infrastructure charges do not include the $15 000 public transport levy, which only applied to case study developments in Blacktown and Baulkham Hills.

Source: HIA (sub. DR260, p. 30); HIA, Canberra, pers. comm., 27 February 2004; HIA, Sydney, pers. comm., 24 March 2004.

Notwithstanding this evidence, developers have been concerned about increasing charges, particularly in relation to section 94 levies in NSW. For example, the HIA (sub. DR260) reported that one Sydney council (Liverpool) has adopted a section 94 plan that allows a levy of $51 224 for lots greater than 450 square metres and $46 447 for smaller lots, including around $14 000 for social infrastructure.

Section 94 of the *Environmental Planning and Assessment Act 1979* enables NSW councils to require developers to improve infrastructure services where a development increases the demand for such services (see box 7.2). Councils implement this by making the granting of a development consent conditional upon the developer contributing land free of cost, making a monetary contribution, or both.

Box 7.2 **NSW section 94 levies**

Section 94 of the NSW *Environmental Planning and Assessment Act 1979* empowers local councils to levy developers for services and amenities rendered necessary as a consequence of development. This may be for the provision of new facilities in a new area, or for the expansion of existing facilities to meet the service needs generated by further development.

Under the Act, councils can require from developers the dedication of land free of cost, the payment of a monetary contribution, or both. The levies thus imposed are generally known as 'developer contributions' and are imposed through development consent.

Councils are required to prepare a Development Contribution Plan (DCP). The purpose of a DCP is to provide public accountability in a document covering the council's policy for the assessment, collection, administration and spending of contributions.

Section 94 of the Act contains a number of principles for levying development contributions, and the Department of Infrastructure, Planning and Natural Resources has produced a guidelines manual to give substance to these principles. The key principles relevant in the decision to prepare a DCP include:

- Nexus between the expected types of development in the area and the demand for additional public facilities created by those developments.
- Reasonableness in terms of the manner of provision, amount of contribution and timing of provision. The courts have suggested that three to five years is a reasonable time to hold contributions.
- Recoupment of costs for facilities already provided in anticipation of future development.
- Assessment of a contribution having regard to any previous contributions (monetary and land dedication).

A DCP has to be in place before a contribution may be required.

Source: NSW *Environmental Planning and Assessment Act 1979*.

Section 94 contributions can be levied for both economic and social infrastructure. For example, the contributions in Penrith have been used to fund road and traffic management, trunk drainage, recreation facilities and a town centre.

Criticism of such 'community' infrastructure charges has been heightened by the recent introduction of the additional public transport levy — equivalent to $15 000 per lot — in four Sydney localities (see box 7.3). The fear is that such charges, additional to section 94 levies, will be introduced more widely.

Box 7.3 **The NSW Transport Levy**

The NSW Government has announced a hypothecated transport levy of $15 000 per lot in four new development areas. The Government has justified the levy on the basis that it would extract what otherwise would be windfall gains to existing owners of raw land from extension of the urban rail system.

The extent of any ensuing increases in property prices will depend on proximity to the rail extension; the degree to which the charge matches the value of the benefit provided (see text below); and, if there is a gap in this regard such that the levy contains a 'tax' element, the relative price responsiveness of supply and demand for land/housing (box 5.2). Any increase in property values is likely for both new developments and existing properties in proximity to the new rail system, suggesting on equity grounds that the levy should be applied to both. Yet it is only applied to new developments.

Access Economics pointed out that this levy is an interim measure and concluded:

> The implicit tensions between the financing of new public transport and the ultimate beneficiaries, as well as the fact that enhanced user charging regimes are currently only available to the State Government through differential ticket prices, suggests that this area is ideally suited to a fundamental review. (sub. 177, p. 45)

However, it is not clear that such a review would provide definitive answers to the issues raised by public transport contributions, given the complexities and tradeoffs involved in this area, and the consequent need for judgments. At the very least, this levy illustrates the need for transparency in infrastructure charging arrangements, underpinned by some clearly enunciated principles (section 7.2).

Both the HIA and PCA also raised concerns about the amount of unspent section 94 contributions. Councils are entitled to retain developer charge revenue for a 'reasonable' period of time, which the courts have interpreted as three to five years (see box 7.2). However, no evidence was provided to the Commission on whether the holding of contributions for longer periods occurs to any significant extent.

Are developer charges affecting affordability?

The impact of developer charges on housing affordability has long been the subject of debate and was again so in this inquiry. The HIA (sub. 177), PCA (sub. 194) and other industry representatives argued that developer charges are passed on in full to home buyers through prices paid for serviced land and for house and land packages, thereby reducing affordability. However, in line with the position previously put by Abelson (1999), others claimed that these charges are largely passed back in the form of lower values for raw housing land and therefore have little impact on house prices.

The incidence of developer charges

Developer charges are a form of user pays charging, involving the upfront payment for infrastructure. Hence, though there are parallels with the analysis of the incidence of housing taxes (chapter 5), an important distinction is that a developer charge is used to pay for services that enhance the value of serviced land or a new home. In contrast, revenue raised from taxes on housing (such as a land tax) provides no specific benefit to home buyers.

In general terms, this suggests that if the value to home buyers of infrastructure financed by a developer charge is more or less equal to that charge, then home buyers would willingly meet the higher cost in the price paid for serviced land or a house and land package. The implication is that such charges could, and would, be passed in full to the buyer.

Conversely, if the perceived value of the infrastructure is less than the charge, then that charge will effectively incorporate a tax component. This component will be shared between buyers and the owners of raw land in line with the tax incidence analysis in chapter 5. In this case, the charge would not be passed on in full to the final buyer, and the price of raw housing land would fall somewhat. However, the various requirements now in place to ensure that there is a nexus between service provision and need, and that charges reflect the efficient costs of supply (see below), together suggest that any 'tax' component in developer charges is likely to be relatively small.

The proposition that soundly-based developer charges should be passed on to home buyers need not be at odds with the view that a shift to upfront developer charging, *which simultaneously involves the removal of subsidies on the infrastructure concerned*, may see a significant element of 'pass-back' to the value of raw housing land. In line with the tax incidence analysis in chapter 5, where infrastructure has previously been provided to households below cost, the value of that subsidy will have been partly, or largely, capitalised into the price of housing land. It follows that the removal of those subsidies, as part of a shift to upfront developer charging, will see the value of undeveloped land fall. This in turn means that the cost of serviced land, and house and land packages, will rise by less than the full amount of the upfront developer charge. But such 'pass-back' of charges in this situation is clearly due to the unwinding of subsidies, rather than to the switch in the type of user payment to upfront charging.

Impacts on affordability

While the incidence effects of a move to upfront charging are complicated if there is a simultaneous removal of subsidies on the infrastructure concerned, the impacts on affordability are much clearer.

In the case where all that is involved is a change from payment over time to payment upfront, the increase in the cost of serviced land or new homes to reflect a 'prepayment' for infrastructure should, in principle, lead to a matching reduction in ongoing housing costs. That is, while a move to charging upfront will require households to take out larger mortgages, ongoing utility charges and council rates will be lower than otherwise. Households would be no worse off over time.

Moreover, where the move to upfront developer charging involves the simultaneous removal of subsidies on infrastructure provision, higher charges for that infrastructure will be largely offset by a fall in the price of raw housing land. The corollary of this argument is that, even if more of the cost of providing infrastructure to new developments were shifted onto the wider community, housing affordability might not be greatly enhanced. That is, the price of land in new housing developments would rise, meaning that the gains from lower infrastructure costs would be largely captured by the owners of raw land or by developers.

In summary, greater use of upfront developer charging is unlikely to have any substantial effect on housing affordability, irrespective of whether infrastructure was previously subsidised. However, as discussed below, depending on the borrowing criteria applied by lending institutions, it may make it somewhat more difficult for 'marginal' home buyers to enter the market.

7.2 Principles and practice

The preceding discussion illustrates that upfront charging in itself should not be of concern on either efficiency or affordability grounds. However, industry representatives claimed that a variety of other aspects of infrastructure charging policies are also of concern. These include:

- charges inappropriately imposed on individual developments, when they should be spread more widely;
- charges or standards for infrastructure provision that are excessive for their given purpose, sometimes because of 'gold plating' to minimise future maintenance costs for councils;

- residents of developments effectively paying twice for some items through both upfront charges and rates or ongoing charges (double charging);
- funds not being spent on the designated purpose; and
- lack of scope for, or excessive costs in, appealing against particular charges or requirements.

Some key requirements

In principle, there is a strong case on both fairness and efficiency grounds for the user or beneficiary of a good or service to pay for what they receive. A charge on users, if it reflects the true costs of supply, ensures that demand is not excessive and resources are not wasted. In the case of housing infrastructure, such linkage between the benefit received and the payment made is particularly important in helping to ensure that the level of investment in housing reflects its opportunity cost, and that efficient locational choices are made.

Most infrastructure is 'lumpy', with high capital costs and relatively low running costs. Moreover, these fixed capital costs can vary across locations. Hence a critical policy issue is how best to apportion the fixed costs of infrastructure provision across users or beneficiaries so that charges:

- fully recover costs; and
- encourage a spatial pattern of housing development that reflects underlying costs.

Allocating costs among users

In general terms, the appropriate allocation of capital costs hinges on the extent to which a given piece of infrastructure provides services to those in a particular location or development, rather than across the community.

For a 'private' capital item — such as the sewerage pipes that connect individual houses to collector and trunk lines — all the capital (and ongoing) costs should be borne by the households concerned.

But for a 'communal' item of infrastructure, benefiting a wide group across the community — such as a major sewerage treatment plant — some form of mechanism for allocating costs across dispersed beneficiaries is required. The simplest option, for example, is that all beneficiaries contribute equally towards the capital costs.

Self evidently, the dispersion of benefits across the community will vary considerably for individual items of infrastructure. Indeed, major utilities typically supply infrastructure that spans the spectrum from assets benefiting only households in particular developments to systems servicing large parts of major cities. Such diversity adds to the complexities of apportioning the costs in an efficient and equitable manner over time. Typically, tradeoffs will be required between efficiency, equity and administrative costs.

Allocating costs over time

For the reasons outlined above, if charges for infrastructure services are commensurate with the value of the service provided and are properly allocated, it should not in principle make any difference to affordability whether those charges are levied upfront or over time. Either way, the home owner will effectively pay for the services over time: through higher mortgage repayments, higher charges, rates or taxes.

However, the distribution of benefits across users, and hence the way in which costs should be allocated, may impact on the timing of charges. For example, as discussed below, where the benefits are widely distributed across the community, cost recovery through council rates and/or regular payments for utility services may deliver more efficient and equitable outcomes than seeking to recover some costs through upfront charges.

Moreover, there could be a difference for housing *accessibility* if lenders take no account of home buyers having larger disposable income in the *future*, and hence the capacity to repay a larger loan, when developer charges are levied upfront. As the HIA argued:

> There is no assurance that home lenders will increase automatically loan-to-valuation ratios or repayment capacity limits when new house prices are affected by increases in development charges. (sub. DR260, p. 22)

Some lending institutions have now adopted lending rules which take greater account of households' capacity to repay a loan from a given income (chapter 3). But it is not clear that under current arrangements, this would typically extend to making allowances for the effects of upfront payments for infrastructure on the income required to pay council rates and ongoing utility charges.

Application of efficient and equitable charging practices

Various means to facilitate efficient and equitable apportionment of costs are employed around Australia. For example, most utilities providing housing-related

infrastructure are subject to regulatory controls on the charges they can levy on both developers and home owners (see below). Also, under Victorian legislation, local governments must prepare 'Development Contribution Plans' for the purpose of apportioning costs, based on common law principles of 'need, nexus, equity and accountability' (see box 7.4).

Box 7.4 **Established principles for development contributions**

Need — demonstrating that a development is likely to create a need.

Nexus — demonstrating a connection between the need and the infrastructure provided.

Equity — the amount charged must be a fair and reasonable apportionment of the cost.

Accountability — revenues need to be spent on the infrastructure for which it was collected.

Source: Victorian Government (sub. 85, p. 29).

Although such general principles seem appropriate as far as they go, industry representatives expressed concerns about their application in practice. These mainly related to the interpretation of 'nexus', how existing residents are treated, whether standards of infrastructure are appropriate and costs are efficient, and whether it is appropriate for home buyers to pay upfront for some types of infrastructure.

Such issues are best addressed separately for the three broad categories of infrastructure: basic, major and social.

'Basic' economic infrastructure

There is no dispute that home buyers should pay for the minor infrastructure works on their own properties or those linking their properties to local networks. There is also general agreement that the cost of such local infrastructure networks should be borne by residents of the developments concerned. The practice of developers constructing local roads, paving and guttering and hydraulic systems, and contributing these assets to local government, is of long standing.

This charging practice clearly meets the tests of demonstrated need and nexus and, with the assets being predominantly used by or for the benefit of local residents, it is also equitable that they pay the full costs. Accountability is promoted when residents bear the costs of providing the assets. It is also more efficient and convenient to have such infrastructure installed when the land is being subdivided.

Further, there are advantages in paying for these assets upfront. While councils and utilities have in the past funded such infrastructure and charged residents through hypothecated levies, with a proliferation of developments, the transactions costs of operating a levy regime could now be high. Moreover, as Access Economics has noted, this would involve councils and general ratepayers bearing the risk of a development not being successful (sub. 177).

However, one potential problem with funding such infrastructure through developer contributions, is that councils and utilities could have both the incentive and the scope to insist on standards that are excessively high, either in relation to what home buyers want, or to the efficient costs of providing infrastructure over the whole life of the assets. Some participants suggested, for example, that councils might do this in order to reduce maintenance and replacement costs in the future, when assets are their responsibility.

To the (possibly limited) extent that developers can pass on any excessive costs, housing affordability will be reduced. An onus on councils to justify standards on a whole-of-life costing basis would therefore be desirable.

That said, the scope for councils to 'gold plate' their assets will tend to be reduced by competition between municipal areas to attract developments (or, for utilities, by regulation, where this applies). Moreover, some governments and independent regulators have or are in the process of issuing guidelines that provide developers with the opportunity to comment on infrastructure development plans. And some utilities allow developers to propose alterations to these plans. Such mechanisms will tend to be a further constraint on gold-plating behaviour.

'Major' (shared) economic infrastructure

The 'beneficiary pays' approach is not straightforward when applied to networked infrastructure investments that are both required for a particular development and shared with other developments. Specifically, the extent to which any investment will be used by those in the development relative to others has to be established.

Even so, the Commission sees considerable merit in the use of upfront charging to finance major infrastructure where the incremental costs can be well established and, in particular, where such increments are likely to vary across developments (because of location and terrain). This suggests, for example, that the costs of trunk infrastructure provision, such as water mains or collector sewers, should be attributed in line with incremental costs.

One advantage of upfront charges or developer contributions for this type of infrastructure is that they can potentially accommodate 'out of sequence'

development — where land is not developed contiguously along networks of major infrastructure. Out of sequence development can help to overcome constraints that adversely affect the responsiveness of housing supply, such as fragmented land holdings, thereby reducing price pressures arising from an increase in demand. If developers bear the holding costs of infrastructure that has been provided ahead of schedule, utilities should be indifferent about meeting the infrastructure requirements of this type of development.

In this inquiry, the Commission has not been able to review in detail how charging decisions for major economic infrastructure have been made and implemented. However, while charges for major economic infrastructure can be significant in some cases — and appear to be becoming more important (for example, the $15 000 NSW transport levy) — case study evidence cited above indicate that to date they have been dominated by basic infrastructure costs. (Indeed, in the Wyndham (Victoria) example, there were seemingly no charges imposed for major infrastructure). Moreover, the Commission's examination of charging regimes for water supply, drainage and sewerage in Sydney and Melbourne revealed that most authorities are applying the principles in box 7.4. These arrangements have been established in consultation with developers and appear to have attained broad acceptance.

That said, the Commission considers that investment to install, upgrade or augment system-wide components that provide comparable benefits to users in long-established areas, would in principle be better funded out of borrowings and recovered through rates or taxes (or the fixed element in periodic utility charges). This would include, for example, water supply headworks and major sewerage treatment plants.

The PCA (sub. 194) argued that debt financing of capital costs should play a larger role generally, with repayments funded by the whole community through taxes or rates. The Commission would endorse this for infrastructure that provides benefits that are widely distributed across the community, provided that adequate disciplines exist for cost recovery and debt repayment over the life of the assets.

The case for debt financing should not, however, hinge on the public sector's lower borrowing costs, as the analysis undertaken by the Allen Consulting Group on behalf of the PCA seems to suggest. Public borrowing costs are lower largely because of the implicit government repayment guarantee, based on the taxing power of the state and the associated (involuntary) transfer of risk to taxpayers. If the argument about the public sector's lower borrowing costs were taken to its logical extreme, governments would borrow on behalf of the community for all major assets. The well documented cost recovery and debt repayment problems that have characterised various major government-funded investments are a further caution on

the extensive use of this financing approach. In any event, public utilities already have the option of borrowing to fund major infrastructure investments, and recovering the costs through user charges.

It is of course important that whatever charging mechanisms are employed for major infrastructure, costs are not excessive and are apportioned on an appropriate basis. In general terms, this requirement is no different to the charging principles that should apply to basic infrastructure. However, a specific concern raised by the HIA and others is the scope that exists for new home buyers to pay twice for major infrastructure — once upfront through the pass-through of developer contributions, and again through general property rates or taxes, or regular payments made for utility services.

Conversely, in its response to the Discussion Draft, the Municipal Association of Victoria (MAV) submitted that councils should be entitled to apply development contributions in new urban development and still charge the same general rates to all property owners in the municipality. In essence, the MAV argument is that rates, being a general revenue source equivalent to taxation, are not bound by the user-pays principles that apply to developer charges (sub. DR272, pp. 1-2).

For the reasons outlined above, over-recovery of the capital costs of major infrastructure from developments subject to upfront developer charges will not necessarily increase proportionately the prices of the serviced land and the houses affected. As this would amount to a tax on those developments, much of its impact on house prices may be offset by falls in the value of the undeveloped land.

Even so, the Commission does not accept that over-recovery is a legitimate practice. It would seemingly contravene standard equity principles, particularly if the proceeds are used to cross subsidise infrastructure provision to those living in established, more expensive areas. Moreover, as a non-transparent source of taxation revenue to local governments, it may undermine incentives for cost effective service delivery by them.

Thus, it is not surprising that a variety of regulatory measures have been put in place to reduce the likelihood of double charging. For example, the Independent Pricing and Regulatory Tribunal in NSW has developed guidelines on developer charges and also monitors usage charges levied by utilities (see box 7.5). These guidelines also require utilities to expose infrastructure development plans to public scrutiny.

Box 7.5 **Regulation of utilities' developer charges in NSW**

In NSW, the Independent Pricing and Regulatory Tribunal (IPART) regulates the maximum charge that the four water agencies under its jurisdiction can levy for water, sewerage and drainage services. This includes setting the maximum water and sewerage charges levied, and also more specialised charges such as developer charges.

Rather than setting individual developer charges, IPART determines a methodology for fixing the maximum developer charges.

Water agencies must advertise and exhibit a Development Servicing Plan (DSP) describing the area covered and assets used, and the basis on which the developer charge has been calculated.

Once prepared, the agency is required to exhibit the DSP and invite public comment.

A developer who is dissatisfied with how an agency has calculated a developer charge, may have the dispute arbitrated under section 31 of the *Independent Pricing and Regulatory Tribunal Act 1992*.

Developers have argued that insufficient information has been made available to enable them to asses the appropriateness of the assets used to service a development and the basis on which the charge has been calculated.

IPART responded to these criticisms in September 2000 by requiring revised publication processes for DSPs. In particular, IPART now requires a minimum 30 day exhibition period and more detailed and transparent exposition of the calculations involved. In addition, the agencies must inform the Urban Development Institute of Australia, the HIA, and any relevant developers and landowners of the start date of the exhibition period, at least ten working days beforehand.

It is notable that some utilities seek to avoid over-recovery by having explicit regard to the element of subsequent cost recovery in determining periodic charges or rates. For example, Sydney Water and Yarra Valley Water in Melbourne subtract future contributions to capital (above recurrent costs) made through ongoing charges, from the capital costs of new infrastructure. And, some regulators exclude contributed assets from the regulatory asset base when determining ongoing charges (see box 7.6).

In the Commission's view, there would seem to be a good in-principle case for councils as well as utilities to have regard to the element of prospective capital cost recovery through (uniform) rates or other periodic charges when setting developer contributions. However, as developer contributions must be set in advance, this might not be straightforward. Similarly, the alternative approach of adjusting rates to reflect upfront contributions towards infrastructure costs by some households could also raise administrative problems.

Box 7.6 Sydney developer charges for water, drainage and sewerage infrastructure

In 2000, the NSW Independent Pricing and Regulatory Tribunal (IPART) reviewed the basis of setting developer charges for the provision, or upgrading, of water supply, sewerage and drainage facilities. The review was undertaken because of industry concerns about the application of the methodology used since 1996.

Among other things, IPART determined that from 1 October 2000:

- In keeping with the general provisions applying in NSW (see box 7.5), Sydney Water must prepare a Development Servicing Plan (DSP) to a specified format and promulgation process. DSPs, and therefore developer charges, are to be reviewed every five years.
- The charges are set to recover the difference between the capital cost of an asset and the agency contribution (the net present value of the difference between operating revenue and operating cost). The contributions are only for assets that have a clear nexus with the development. They extend to headwork and sewerage plant, as well as trunk connections.
- Assets are valued using an optimal replacement cost methodology.
- The discount rate for assets commissioned after 1996 is to reflect the opportunity cost of capital (the weighted average cost of capital). A holding charge is to apply from 1996 for assets commissioned between 1970 and 1996. The amount to be recovered is to reflect the interest foregone on the capital tied up in the infrastructure between the date of commissioning and the date at which the charge is determined.
- The amount to be recovered through charges is to be apportioned among developments on a per hectare or Equivalent Tenement (ET) per development basis (a measure of the demand a development will place on the infrastructure). The charges per ET vary by location and reduce as land use density increases. The charges are discounted to deal with the staged release of blocks in large developments that span a number of years.
- Disputes over the application of the methodology should be resolved by the parties concerned. However, there are mechanisms under IPART's legislation for resolution of disputes.

Source: IPART, 2000.

But in the Commission's view, these difficulties do not validate the practice of double charging, or detract from the case for upfront charging where the benefits of investment in infrastructure can be attributed to a particular group of households rather than being spread widely across the community.

The fact that some utilities are making adjustments to avoid double charging suggests that the problem is not insoluble and not a reason for abandoning otherwise

efficient and equitable upfront charging. Indeed, adoption by councils of the general charging principles set out by the Commission in the final section of this chapter would make it incumbent on them to look for ways to make similar adjustments either to their developer contributions or rating regimes.

'Social' infrastructure

As noted, there has been an increasing tendency to fund social infrastructure through developer charges or contributions. This may include contributions towards sporting and recreational facilities (parks and open space), libraries and community centres.

Such infrastructure may sometimes satisfy an identifiable demand related to a particular development (for example, a neighbourhood park or recreational facility used predominantly by local residents). In these cases, the costs should be allocated to that development, implying that upfront developer charges may be an appropriate financing mechanism.

In most cases, however, the beneficiaries of the services are likely to be dispersed throughout the community. Reflecting this, such services were traditionally funded from general revenue sources drawn from the wider community. But charging practices have become more diverse. For example, Queensland legislation does not allow local governments to charge developers for social infrastructure; in Victoria charges have been capped at $450 per lot (although the Government has recently announced that this will be removed); and, as previously noted, in NSW, section 94 provisions already give broad discretion to local governments to collect contributions for social infrastructure.

Most of the concerns about upfront charging for social infrastructure have therefore focussed on NSW. However, debate has been clouded by the lack of precision in terminology noted previously, with the terms 'community' and 'social' infrastructure being used to encompass major economic infrastructure. That aside, it seems clear that in NSW, the 'pure' social component of developer charges has increased and some other states appear to be following suit.

Various cost allocation mechanisms could be employed to set developer contributions for social infrastructure that provides broadly-based benefits to the community as a whole. In this regard, in responding to the Discussion Draft, the MAV (sub. DR272) submitted that the Robins Review of the Development Contributions System in Victoria provides one such allocation mechanism (see box 7.7). This would require councils, as part of their strategic planning, to establish

how much social infrastructure is required and how much of the benefit would accrue to each development; and then apportion charges accordingly.

Box 7.7 **The Robins Review's proposal for apportioning social infrastructure costs**

The following eight step approach to apportioning the costs of social infrastructure with community-wide benefits has been proposed in the report of the Robins Review of the Development Contributions System in Victoria.

Step 1 — Divide the municipality up into small 'analysis areas'. These can be Census Collectors Districts, or areas of similar size in districts where major development is expected.

Step 2 — Make an inventory of existing development and project future development in each analysis area. All development which generates demand for infrastructure is to be included.

Step 3 — Convert all existing and projected development into common 'Demand Units' using suitable equivalence ratios. A margin should be added to the Demand Units in each analysis area to allow for 'undefined' or non-standard land uses which might arise.

Step 4 — Identify the infrastructure projects to be included in the developer contribution plan and document their justification. Projects must be essential to health, safety and well being or consistent with current community expectations of what is required to meet its health, safety and well being, and likely to be used by a broad cross section of the community. Project provision standards must not be 'gold plated'.

Step 5 — Identify the Main Catchment Area of each project and estimate the percentage of external usage.

Step 6 — For each project in turn, calculate the Infrastructure Charge (IC), which should apply in its Main Catchment Area.

IC for Project = (Project Cost – per cent of external use) / Total Demand Units

Project Cost and Total Demand Units are to be expressed in present value terms to allow for cash flow effects.

Step 7 — Add up the Infrastructure Charges applicable in each 'analysis area'.

Step 8 — Aggregate the 'analysis areas' and their respective Charges into Planning Units. In aggregating 'analysis areas', care should be taken not to introduce excessive cross subsidy into any Planning Unit.

Source: MAV (sub. DR272).

Notwithstanding the desirability of at least using a systematic approach, the Commission's view is that, for social infrastructure that provides broadly-based benefits to the community as a whole, accurate cost allocation will be extremely difficult, if not impossible. Hence, requiring developers to contribute upfront to

finance the costs of providing such infrastructure will almost inevitably lead to inefficiencies and inequities. In some circumstances, general revenue may be the only realistic option for financing such services. Though where 'exclusion' from access to the service is possible — as in the case of a community swimming pool — direct user charges provide an alternative and more efficient means of recovering costs.

7.3 Conclusions and policy implications

Notwithstanding the complexity of this area, some general messages emerge from the preceding discussion:

- Infrastructure charges, like other costs of bringing housing to the market, have increased over time. But they cannot explain the surge in house prices since the mid-1990s. Indeed, the share of total house prices accounted for by infrastructure costs appears to have been declining in most Australian cities.
- The claimed cost savings and improvements in affordability from reducing reliance on developer charges for infrastructure appear overstated:
  - Most categories of charges are justified and indeed are desirable on efficiency/equity grounds. (Reduced reliance on developer contributions would bring a requirement for similar dedicated charges to be collected from home buyers.)
  - Housing affordability should not be significantly affected by greater reliance on upfront charging as opposed to charging over time.
  - Developer charges for those items of social or economic infrastructure that provide benefits in common across the wider community have generally been relatively small — though such infrastructure should desirably be funded out of general revenue sources.

Nonetheless, though changes in the level and form of infrastructure charges are not responsible for recent sharp declines in housing affordability, compliance with some general charging principles will help to promote more efficient and equitable outcomes.

RECOMMENDATION 7.1

Developer charges (and charging for infrastructure generally) should be:

- ***necessary — with the need for the services concerned clearly demonstrated;***
- ***efficient — justified on a whole-of-life cost basis and consistent with maintaining financial disciplines on service providers by precluding over-recovery of costs; and***
- ***equitable — with a clear nexus between benefits and costs, and only implemented after industry and public input.***

RECOMMENDATION 7.2

Investments in items of social or economic infrastructure that provide benefits in common across the wider community should desirably be funded out of borrowings and serviced through rates, taxes or usage charges.

Charges are more likely to satisfy the above principles if the processes for establishing and applying them are sound and transparent. Further, efficiency would be enhanced if charging regimes provide developers with some flexibility in the timing of developments and the design of the infrastructure.

RECOMMENDATION 7.3

Authorities and utilities imposing developer contributions and charges should:

- ***follow guidelines based on principles set out in recommendations 7.1 and 7.2 and be subject to independent regulatory scrutiny;***
- ***provide for 'out of sequence' development if developers are prepared to meet the cost consequences;***
- ***be open to proposals for alternative infrastructure arrangements that meet the needs of the households concerned;***
- ***allow appeals on the amounts charged, or their coverage; and***
- ***be accountable for how money raised from charges is spent.***

The Commission recognises that these principles and practices ostensibly apply already to much existing charging for housing-related infrastructure. There is also substantial regulatory oversight of the charging practices of utilities. However, especially at the local government level, current practice provides scope for improvement.

8 Are industry performance and building regulations appropriate?

Findings

- The land development, (detached) housing and building materials industries appear broadly efficient and competitive.
  - While in some areas land developers may have a degree of market power, other housing developments, the potential entry of new developers and the existing housing stock all limit the scope for overpricing.
- Productivity in the commercial building sector — which is responsible for constructing higher-density residential dwellings — appears to be below that in several other countries and well below that in the detached housing sector within Australia.
  - While other factors are also relevant, work practices in the commercial building sector could clearly be improved. Such improvements could reduce some of the potential costs of urban consolidation policies.
- An effective regulatory framework for workplace arrangements in the building and construction industry is important to promote improved work practices by construction companies, employees and unions.
- Governments can help address shortages of skilled workers by ensuring institutional impediments do not restrict the matching of skill development to industry needs, and that the funding of training is efficient and effective.
- Building regulations should only be introduced after rigorous benefit–cost assessment, including the consideration of alternatives for achieving underlying goals.

There is some evidence of recent cost increases in particular areas of the land development, housing construction and building materials industries. These increases, however, have been minor compared to the price increases for established housing (including land).

Nevertheless, improvements in industry performance and reductions in regulatory burdens affecting housing could reduce costs and provide enduring improvements in housing affordability. Areas of particular importance raised by inquiry participants are considered below — these relate to the competitiveness and

productivity of the abovementioned industries, industrial relations, shortages of skilled workers and trade contractors, and building regulation.

8.1 The land development industry

A number of inquiry participants questioned the extent of competition in the land development industry. In particular, concerns were raised about the capacity of some developers to exercise market power and restrict the supply of land for housing, leading to upward pressure on house prices (Pollard, sub. 94; Planning Institute of Australia (PIA), sub. DR271).

More specifically, some contended that land developers engage in 'land banking' (holding land but not developing it) or 'drip feeding' (deliberately releasing land slowly so as to increase prices). For example, the PIA stated:

> Speculative land withholding is, arguably, a serious factor militating against housing affordability in some greenfield sub-markets … Anecdotally, major land owners and developers with a dominant position in particular markets, may be prone to the (oligopolistic) practice of sluggish land release, as profitability may not necessarily be boosted through more timely production of finished lots. (sub. DR271, pp. 4–5)

Although acknowledging that there can be spatial monopoly in some areas, the Urban Development Institute of Australia (Victoria) (UDIA, trans., p. 254) claimed the industry is mostly competitive, with no developer holding more than around 5 per cent of the market in Victoria. Further, the Master Builders Association of Victoria (MBA, sub. 188) said that although some developers 'drip feed' the amount of land released to builders, few in the industry engaged in land banking.

Other participants argued that the industry is highly competitive and is not restricting supply. These included the WA Government, which observed:

> There is no evidence that land developers have unduly withheld land supply in order to bolster prices (although, of course, it is the prerogative of land developers to plan to release land at a time which potentially maximises their commercial returns). (sub. 190, p. 36)

The WA Government also argued there were no 'impregnable' barriers to entry to the land development industry, and that a number of small developers were monitoring the market strategies of the larger developers and taking advantage of market gaps. Wyndham City Council (trans., p. 290) similarly highlighted that neighbouring developments helped to constrain any market power in the Wyndham area.

Overall, the evidence available to the Commission is not sufficient to establish whether or not land banking or 'drip feeding' by land developers is a material problem. However, the Commission agrees that there are significant limits on the potential returns land developers may gain from such behaviour.

Moreover, land banking or the slow release of land is not necessarily a sign that developers are exercising any substantial degree of market power. For example, it may show the need for land developers to recoup capital costs before undertaking further investment. Land developers might also be waiting for additional information on matters such as infrastructure development before committing resources to a project.

That said, and as the Barker (2003) review noted, in some cases there may be a coincidence of interests between land developers, existing home owners and local councils to limit housing output, especially in infill areas. For this reason, it is important that government policies do not reinforce any such incentives to limit supply, but rather promote efficient outcomes that account for the need to meet increases in housing demand.

On this latter point, several participants suggested that government participation in the market for serviced land may sometimes be beneficial. For example, the PIA argued that the market can fail to produce efficient outcomes because of the fragmentation of available land. To address this problem it suggested a government agency could buy fragmented land, package it and on-sell it to developers:

> One of the principle constraints to the rapid release of sites for urban consolidation around railway stations, activity centres and other suitable locations is the fragmentation of landholdings. The time and risks involved in assembling sites that can accommodate reasonable projects in these areas acts as a major disincentive to private sector production … (sub. DR271, p. 6)

The UDIA (Victoria) (trans., p. 255) proposed a similar facilitation role for government in land development, including tasks such as aggregating disparate land holdings, overcoming planning issues and putting land packages to the market, claiming that this would reduce risks for land developers. Several government agencies currently undertake such activities, including VicUrban (Victoria), Land Management Corporation (SA) and Homeswest (WA). Some also undertake land banking to help manage fluctuations in demand and keep residential land prices down.

In the Commission's view, it is unclear how far governments can improve on market outcomes by purchasing, packaging and on-selling land. Government involvement in the market as a purchaser is not without costs, such as the opportunity cost to the community of governments holding land stocks (IC 1993a). Nonetheless, in keeping with their broader planning responsibilities, there may be

some role for governments in this area. In particular, governments may be able to take a long-term perspective that has greater regard to external effects on the community (often significant in urban areas), and assists urban and land use planning.

Governments can also affect the degree of competition in land development through land release and zoning policies. The UDIA (Victoria) considered that government land release strategies and zoning in some growth areas have restricted development opportunities, and thereby the number of developers and competition between them. Policies covering the release of government owned land are also relevant in this regard (chapter 6). On the other hand, the WA Government (sub. 190) argued that the public nature of its Urban Land Release Policy process places pressure on developers to prevent them from delaying land release.

In conclusion, the Commission considers that the land development industry is broadly competitive. Although spatial monopolies may exist in some areas, the potential entry of new developers, and the existence of neighbouring housing and developments, help to limit market power. However, it is important that government policies on land development, land release and zoning do not inadvertently reduce competition and land supply.

8.2 The residential construction industry

Inquiry participants stressed that the residential building construction market is also competitive, especially the detached housing sector which is characterised by large numbers of small- and medium-sized firms and individual operators.

While barriers to entry have increased in recent years because of growing regulation and more expensive insurance, there remain a large number of businesses competing for building work. Moreover, while the market share of large building companies providing project homes has increased, this has tended to stimulate competition, with cost increases for project houses (excluding land) having been relatively modest over the last decade (see figure 6.1).

There were concerns about the competitiveness of some sections of the commercial sector involved in high-rise and medium-density residential construction, where there are fewer and larger businesses. But even here, there is a sufficient number of suppliers, along with the presence of the detached housing sector, to ensure that the market is kept competitive. According to the Housing Industry Association (HIA 2002), the market share of the top four dwelling construction firms in each state is less than 40 per cent.

In terms of productivity, at least two studies in the mid-1990s found that the Australian construction industry compared favourably with its European and North American counterparts:

- Pilat (1996) found that labour productivity in the Australian building and construction sector was above that in the United States, Japan and all European nations. Only Canada had higher building and construction output per person.
- Lewis et al (1996) similarly found that the Australian industry was close to world's best productivity.

However, a study in 1999 on the cost of construction across several countries ranked Australia in the middle in terms of performance, and below other highly industrialised countries assessed (DISR 1999). Further, Commission estimates (PC 2003c) suggest that multifactor productivity in the construction sector, though fluctuating from year to year, is now little higher than in the early 1980s.

A recent PricewaterhouseCoopers (2002) study also suggested that the pace of innovation in the building and construction industry in Australia has been below that of other countries such as the United Kingdom, France, Spain, Germany and the United States. Industry risks and price volatility were considered major inhibitors to innovation. However, the picture emerging from the study is not uniform across sectors within the building and construction industry, with some sectors investing significantly more in research and development than others.

Further, the *Royal Commission into the Building and Construction Industry*, which reported in 2003, found that several areas of the industry required reform and that productivity growth in the industry was below average for the market sector of the economy. As discussed in section 8.3 below, the Royal Commission's findings are particularly relevant to apparent differences in productivity between the residential and commercial construction segments of the industry.

Several participants to this inquiry also focused on differences in productivity between residential and commercial construction. For example, the HIA (sub. 177) argued that labour productivity in the commercial construction sector is well below that in the domestic residential building sector. More specifically, a study by Econtech (2003) suggested that lifting productivity in the commercial sector to the same level as in the residential sector would reduce commercial construction costs by 6 per cent. Such improvements in productivity would, by reducing costs in inner urban areas, help reduce the potential cost impacts of state government urban consolidation policies (chapter 6).

Building materials

There is general agreement that the building materials industry is broadly efficient, and has not contributed significantly to recent house price increases. As noted in Chapter 6, building material prices have remained relatively constant in real terms over the last decade (see figure 6.1). Further, despite rationalisations which have reduced the number of operators in some areas, most building materials markets appear to be broadly competitive.

8.3 Industrial relations

According to industry representatives, industrial relations arrangements in the construction sector are inflating building costs. The HIA raised two specific concerns:

- the unclear legal treatment of trade contractors, and possible moves to deem them as 'employees' and bring them within the industrial relations system; and
- the industrial relations climate in higher density developments.

On the first matter, the HIA noted that most housing construction is performed by trade contractors and that 'extra and unnecessary administrative costs are imposed on the housing sector by the unclear legal treatment of these contractors' (sub. 177, p. 71). The essence of the HIA's concern is that under both common law and specific legislation, trade contractors are treated as independent contractors for some purposes and as employees for others.

Accordingly, the HIA recommended that legal security for the status of trade contractors should be provided through all governments recognising that:

> … persons who have the status of a Personal Services Business for income tax purposes are independent businesses and should not be treated as employees for any purpose whatever. (sub. 177, p. 72)

The HIA also contended that the 'competitive advantage of trade contractors over unionised employees' would be removed if they were made subject to industrial laws with negative consequences for housing affordability (sub. 177, p. 71). It referred to a study by Econtech in 2002 that projected that housing costs could rise by 20 per cent if work practices in the commercial sector were extended to the detached housing sector (sub. DR260). The HIA emphasised that it had fought hard over the years to prevent trade contractors becoming subject to industrial laws.

However, the Construction, Forestry, Mining and Energy Union (CFMEU) (sub. DR326) disputed the conclusions reached in the Econtech report. The

CFMEU, in claiming that the analytical methodology used in the report was flawed, drew on an evaluation of Econtech's analysis by Toner (2003). The CFMEU further argued that characterising employees as contractors allows employers to avoid obligations under industrial awards and occupational health and safety legislation.

On the matter of work practices and the industrial relations climate in higher density developments, the concerns raised by the HIA mainly relate to Victoria. The HIA claimed that the efficiency of high-rise and medium-density construction in that state is significantly lower than for single-storey domestic dwellings due to differences in work practices:

> While it might be expected that the more highly capitalised and mechanised commercial sector would be more efficient and not less [than detached housing construction], the difference is accounted for by union mandated industrial agreements such as limits on work hours, additional overheads and rostered days off, which restrict productivity in the commercial sector … By contrast, there is little or no union activity in the detached housing sector. (sub. 177, p. 72)

The HIA went on to say that its estimates indicate that the per square metre cost of construction is more than 20 per cent higher for a six storey commercial building than for a six storey residential building, due to different industrial arrangements.

The UDIA (Victoria) (sub. DR276, p. 7) likewise reported that costs could be up to 40 per cent higher on fully unionised sites with similar delays in the duration of construction compared to non-commercial (non-union) sites. Further, the MBA (Victoria) (sub. 188) claimed that the costs of construction in the commercial sector are 20 per cent higher in Victoria than in NSW due to enterprise bargaining agreements entered into with construction unions in Victoria in 1999-00.

The CFMEU (sub. DR326) disputed that there were cost differences between 'comparable' union and non-union sites, and between Victoria and NSW. It argued that any differences between large commercial sites and smaller house building jobs, reflect the different tasks, regulations and equipment involved (such as the use of cranes and hoists), not the existence of union membership. It also contended that the industry is different from state to state and that cost comparisons need to account for these differences.

Issues relating to labour relations and practices in the building and construction industry were the subject of the *Royal Commission into the Building and Construction Industry* referred to above. The Commissioner's final report contained over 200 recommendations to improve workplace relations, industry conduct, contract practices and occupational health and safety (Cole 2003). These included reforms to improve bargaining at the enterprise level, increase accountability for

losses due to unlawful industrial action, improve dispute handling, and establish an independent body to ensure compliance with industry-specific and general laws.

Following on from that inquiry, Federal Parliament is currently considering the proposed Building and Construction Industry Improvement Bill, which would apply to all construction other than projects of less than five single dwellings. The Bill gives effect to a number of the Royal Commission's recommendations, including the establishment of an Australian Building and Construction Commissioner and a Federal Safety Commissioner. The Bill was passed by the House of Representatives in December 2003, and is now being examined by the Senate Employment, Workplace Relations and Educational References Committee, which is expected to report in May 2004.

The HIA considered:

> If [the bill were passed], these cost differentials [in commercial building] would be markedly reduced, as union power to act illegally to maintain their costly agreements would be curtailed. (sub. 177, p. 73)

Inefficient or confrontational labour market practices come at a cost to the industries concerned, to home buyers and to the community generally. In its Discussion Draft, the Commission commented that achieving best practice in workplace arrangements should therefore be an important goal for all parties, and that cooperation between firms, employees and their unions is central to achieving this goal. However, in their responses to the Discussion Draft, some inquiry participants were critical of these comments, with the HIA (sub. DR260) claiming that the Commission had understated the extent of the problems facing the industry in this area and the difficulties of achieving change from within.

The Commission accepts that cooperation and communication can only go part of the way to achieving best practice workplace arrangements, and that there is a need for an effective regulatory framework. The Commission also agrees that there is considerable scope for improvement in industrial relations in the industry. However, the complex legal and industrial relations issues involved in changing the regulatory framework are beyond the scope of this inquiry. Moreover, as noted above, these issues have already been subject to extensive recent review, with specific changes encompassed in proposed legislation currently before Parliament.

8.4 Skilling issues

In recent years, industry associations have become increasingly concerned about shortages of skilled workers in the building industry and its subtrades. Indeed, the HIA considered there are now 'chronic skills shortages':

> Skill shortages in the residential building industry have the potential to dramatically increase the cost of construction and therefore affect housing affordability. In several previous booms in construction activity, severe skill shortages dramatically increased costs and with increasing skill shortages forecast in the next 7-10 years, it is important this issue is addressed. (sub. 177, p. 73)

According to the MBA, shortages are most pronounced in NSW and Queensland (sub. 135, p. 30).

Ageing of the workforce, difficulty in attracting new entrants, and a declining trend in apprenticeship numbers were some of the specific problems identified by participants. To address them, the HIA saw a need for 'the provision of more flexible and accessible training options tailored to address specific areas of [identified] need' (sub. 177, p. 77).

Although some participants claimed that the collapse of HIH had reduced workforce numbers, evidence of its impact is mixed. The MBA (Victoria) noted that, in that state, building projects were delayed and 435 employees and apprentices were laid off due to the insurance crisis (sub. 188, p. 23). But the HIA contended that, while insurance premiums had since increased, there has not been 'any material change in the number of residential builders in Australia' (sub. 177, p. 14).

In the Commission's view, it is not surprising that shortages of labour, particularly skilled workers, occur from time to time when demand grows strongly. From a policy perspective, the key question is whether firms, industry associations, trade unions, educational institutions and associated training infrastructure have the capacity to respond to such surges in demand so that, over time, short-term skill shortages are overcome.

In this regard, several structural factors may be restricting responses to skill needs and changes in demand, including the design of the training system, regulatory requirements, and resistance from some industry participants. For example, the HIA (sub. 177) contended that the current training for apprentices is too broad and does not account for the specialised skills required for residential building. It also argued that the current training system creates barriers to entry to the industry, restricting adjustment to the changing needs of the industry.

The HIA further pointed to an increasing tendency for state and territory governments to use skill qualifications as a basis for licensing. It argued that if this continues without complementary initiatives to make the training system more flexible, it will create structural barriers that will inhibit the use of subtrade workers.

Other participants also raised concerns about the potential for regulatory impediments to constrain the supply of skilled workers. For example, the Metal

Roofing Industry Association of Victoria (sub. DR233) argued that regulations that compel builders to use registered plumbers to install and repair metal roofs substantially add to the cost of building many houses in Victoria — there are no such requirements in NSW or Queensland. It went on to suggest that a specific roof fixing traineeship replace existing arrangements so that 'increasing demand for steel roofing in Victoria will be able to be met by an increased supply capability' (sub. DR233, p. 1).

Also, the HIA argued that efforts to improve training flexibility have been 'stymied by union and trade association resistance' (sub. 177, p. 75). It said that the main 'sticking point' is the linking of training qualifications to award classifications, with the breaking of this link to achieve more flexible training issues becoming an industrial issue.

In the Discussion Draft, the Commission said that the main responsibility for addressing skilling issues lies with the sector itself and education providers, rather than governments. This position was criticised by some participants such as the HIA (sub. DR260). Nonetheless, the Commission remains of the view that the sector and education providers have considerable responsibility for ensuring the availability of flexible training to meet the sector's changing skill needs. For example, industry has a crucial role in alerting educational and training providers to emerging shortages and problems in the delivery of programs, while providers have responsibilities to tailor and modify programs in response to changing skill needs.

However, governments also have important roles. In particular, they have important funding, facilitation and regulatory roles and, in doing so, contribute significantly to the broad training framework. For example, government funding of training needs to be well designed and periodically reviewed. Among other things, this requires adequate information on skill needs. In this regard, several participants noted that information on skill levels and emerging requirements is currently lacking (for example, HIA, sub. 177). This suggests that an examination of the statistical base in this area may be warranted.

Some changes in policy may also be needed to address particular issues such as rural and regional skills shortages. The Commission notes that the Victorian Government, for example, has instituted a Community Regional Industry Skills Program to deal with such skills shortages (sub. 85, p. 33). In addition, policies in other areas (such as industrial relations) should not unnecessarily restrict the efficiency of the training system, but instead help facilitate flexible and needs-based training.

Finally, it is important that regulations requiring specific skill levels for house building tasks, in aiming to protect consumers and workers, do not add

unnecessarily to costs. While time constraints precluded detailed examination of specific skill-related regulatory concerns raised by participants, these concerns illustrate the importance of periodic regulatory review and the use of regulatory impact statement (RIS) processes when regulations are being developed or amended.

8.5 Building regulation

The construction of dwellings is subject to a variety of building controls and regulations. They affect how dwellings are designed, specified, built and maintained, and, to some extent, how much they cost. The objective of these regulations is to protect the health, safety and amenity of the occupant and the wider community.

Building control is largely a matter for the states and territories. However, under an intergovernmental agreement, the Building Code of Australia (BCA) has been introduced to provide a nationally consistent set of minimum technical standards for the design and construction of buildings. The BCA is maintained and developed by the Australian Building Codes Board (ABCB), a national body funded by the Australian and state and territory governments.

According to the ABCB (sub. 198, p. 5), the intergovernmental agreement seeks a nationally consistent regulatory framework that aims to:

- make building regulation as uniform as possible between the states;
- limit additions or variations by the states as far as possible;
- develop more efficient and simplified building regulatory systems;
- encourage and enhance national acceptance and adoption of improved technology; and
- create an efficient regulatory environment to facilitate an internationally competitive building industry.

Nevertheless, each state, territory and local government is still able to impose specific requirements on the design and construction of new dwellings in addition to the minimum standards contained in the BCA. Building controls for housing are generally administered at the local level, with local governments having some flexibility in interpretation and application.

The ABCB considered that its processes and the BCA have contributed to a better building regulatory system over the past decade (sub. 198, p. 5). Specifically, the Board contended that the arrangements have led to 'a CoAG consistent, national

and rigorous social, economic and environmental evaluation approach to regulatory change proposals’ (sub. 198, p. 5).

A number of other participants also indicated broad support for the BCA process. For example, the MBA noted that it was delivering regulations that generally work from an industry perspective. It also said that current work on creating a new national framework should ‘increase efficiency by allowing national building companies to design and build in multiple states using the same or similar criteria’ (sub. DR256, p. 10).

However, while supporting a national approach, several participants, particularly the HIA (subs. 177, DR260) and the Building Products Innovation Council (subs. 31, 151), raised a variety of problems, including:

- a trend for the states and territories, and even local authorities, to override the BCA;
- slowness of the ABCB to respond to the needs of the states and territories;
- a lack of uniform administrative provisions;
- inadequate processes for approval of alternative solutions and product certification;
- proliferation in the number of standards and in the number of state agencies dealing with building regulation;
- intrusion of planning regulation into building control;
- prescriptive rather than performance-based regulation, particularly in areas such as environmental regulation;
- a lack of integrity and rigour in the RIS process; and
- conflict between the BCA and state fire regulations.

Of specific concern were the processes (or lack thereof) governing changes at the local government level. The HIA claimed that, by including building regulations within planning schemes, local governments are able to bypass the regulatory scrutiny that is applied to the BCA (sub. 177). And, though generally supportive of the current approach, the MBA also referred to problems at the local government level:

> At present, local governments have no need or requirements to go through any RIS or similar process prior to creating a considerable amount of local laws pertaining to buildings and building sites that vary all over the country. The industry has real concerns at the frequency and variations of these ad hoc local government laws. (sub. DR256, p. 10)

In illustrating the effects of such practices, the HIA (sub. 177) said that some local council planning requirements specify higher levels of sound insulation between attached dwellings than the minimum requirements of the BCA, potentially giving rise to numerous insulation requirements throughout Australia. Some participants went on to suggest that such local government requirements can negatively impact on housing affordability. For example, Clarke contended:

> … 'cosmetic'/'aesthetic' building regulations set by local government can reduce housing affordability by imposing unrealistic or expensive requirements on modest new housing developments. (sub. DR283, p. 4)

The HIA estimated that the possible additional cost of changes made to the BCA since its initial adoption in 1997 range between about $5600 and $24 600 per dwelling (sub. 177, p. 90). It further noted that additional costs have resulted from changes at the state level — claiming that in Victoria and the ACT, for example, these average almost $18 000 per dwelling.

Improving regulatory processes

Inconsistencies across jurisdictions, and a lack of certainty and transparency in the administration of building regulations, can increase building costs. But additional regulation, changes to existing regulation and, indeed, regulatory differences between jurisdictions are not in themselves indicators of problems. Regulation has benefits as well as costs. Further, as incomes grow, communities typically seek higher standards in such areas as energy efficiency and environmental protection. Thus, two threshold issues to address are whether the benefits to the community of each particular regulation exceed its costs, including costs of administration and compliance, and whether the regulatory approach proposed is the best option available for addressing the issue at hand.

This in turn focuses attention on whether the processes for determining regulations and the related institutional structures — at the federal, state and local government levels — facilitate proper assessment of the benefits and costs for builders, home owners and for the community generally.

Through the Council of Australian Governments (CoAG), Australian governments have agreed to undertake a RIS for all regulation and quasi-regulation (codes, advisory instruments or notes) made by Ministerial Councils or National Standard Setting Bodies where there is a reasonable expectation of a compliance burden, impact on the community, or restriction on competition. A RIS identifies the need for regulation, and provides an assessment of the benefits and costs of various policy options (CoAG 1997). Consideration of performance-based approaches to regulation is specifically required. Also, RISs developed under these CoAG

requirements must be released for public consultation before being finalised and a regulatory decision made.

As a National Standard Setting Body, the ABCB must prepare RISs for all changes made to the BCA. For example, a RIS was prepared by the ABCB on the impact of the proposed new four star energy standards for inclusion in the BCA. Recently, the Board has also prepared a RIS on proposed amendments to the regulations covering construction of dwellings in bushfire prone areas and the fire hazard properties of building materials and assemblies.

But changes to building regulations, or new regulations, do not always invoke a RIS requirement. In particular, local governments are not subject to CoAG RIS requirements. Hence changes made to building regulations through local planning laws, or other local government instruments, may not be subject to a RIS unless it is required under state law.

In the Commission's view, all proposed regulatory changes should be assessed for their benefits and costs, and alternatives considered. This does not preclude separate regulation at the state and local government level. But there is a need for any differences between jurisdictions to be appropriately justified. The effective and consistent application of RIS processes, at the local government level in particular, could help provide a more transparent and rigorous basis for making such judgments. The Commission would expect that impacts on housing affordability would be addressed as part of any benefit–cost assessment of proposed new building regulation and alternatives.

Another issue raised by the HIA was the need to address the 'creeping [cumulative] impact of changes to building regulations' (sub. DR260, p. 26). While in some instances this issue could be addressed in considering new pieces of regulation, it will often be difficult to deal with using such a piecemeal approach. In the Commission's view, periodic, more wide-ranging reviews of regulatory arrangements may better address issues of regulatory creep.

The Commission has recently been asked by the Australian Government to conduct a research study specifically into national building industry regulatory reform (PC 2004). This will provide an appropriate means of assessing in detail the relevant institutional and administrative arrangements, as well as ways to improve the efficiency and responsiveness of building regulation.

9 Have prices ‘overshot’?

Findings

- Much of the increase in housing prices during the recent boom can be explained by ‘market fundamentals’, especially cheaper and more available housing finance and higher incomes.
  - If sustained, these changes will have brought about a structural shift up in prices.
- Inherent features of the housing market make it prone to price ‘overshooting’. One recent international study concluded that property price booms were three times more likely to be followed by a ‘bust’ than booms in the stock market. Price falls can be substantial, as Australian experience attests.
- While higher incomes, lower interest rates and more accessible housing finance are likely to sustain house prices at higher levels than before, a future softening of prices appears inevitable.
  - Various price and ‘investment-related’ indicators suggest overshooting in parts of the market.
  - Realistic expectations about income and population growth cannot support a continuation of recent rates of house price growth.
  - Calculations that seek to justify current price levels on the basis of low after-tax costs of holding rental properties, ignore emerging risks confronting heavily geared investors.
- Indeed, there is evidence of market cooling, particularly in those segments where highly geared investors have been most active.
- While recent interest rate rises and further price increases in some markets may lead to further declines in affordability in the short term, a more subdued housing market and continued income growth should in due course make it easier for prospective home buyers to enter the market.

9.1 The ‘fundamentals’ explain a lot

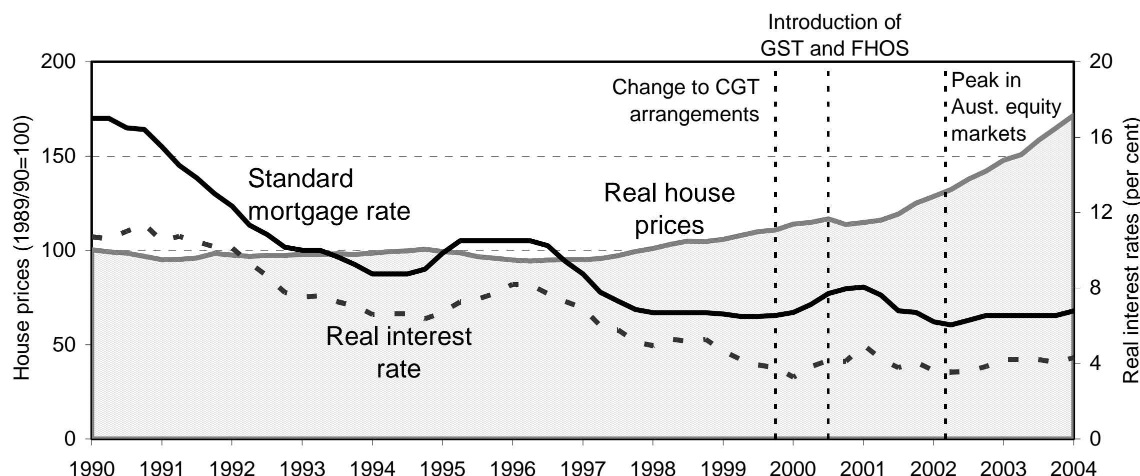
As previous chapters have sought to emphasise, variations in prices and affordability around long-term trends are an inherent feature of the housing market in Australia and other countries.

Moreover, while house prices have risen especially sharply in the last three years, much of the cumulative increase in prices during the recent upturn can be explained in terms of structural and normal cyclical demand pressures:

- Cheaper finance and the growth in average household disposable income have substantially increased the purchasing power of both owner occupiers and investors in rental property. For example, as noted in chapter 3, households can now borrow more than twice the amount in real terms for an owner-occupied dwelling than a decade or so ago.
- More competition among lenders has made it easier to obtain loans and has expanded the range of loan options available to meet the differing circumstances of individual households.
- The downturn in equities markets from 2000 to early 2003, more or less coincidently with changes to aspects of the tax regime, provided strong incentives for investors to shift into residential property.
- Demand has been augmented by the First Home Owner Scheme.

Figure 9.1 provides a timing dimension for some of these demand-side pressures.

Figure 9.1 **Some contributors to demand-side pressures**



Data sources: ABS (*House Price Indexes*, Cat. no. 6416.0; and *Consumer Price Indexes*, Cat. no. 6401.0).

Some of the ‘structural’ demand-side drivers — most notably growth in household disposable income and increases in population — will continue to put upward pressure on house prices in the future. However, short-term cyclical demand pressure from the previous downturn in the share market now appears to be reversing. Similarly, the shift up in house prices associated with cheaper and more available finance may largely have run its course, and will prove to have been a

structural change if low inflation continues to support the sort of interest rate levels that have prevailed in recent years.

But whatever their likely future impact, over the past few years, these demand-side pressures have led both owner occupiers and investors to seek to increase their exposure to property, including through higher quality and better located houses.

Given the scarcity of well located land, and the inherent 'stickiness' in the supply of housing, this increase in demand would have caused land and house prices to rise, irrespective of the efficiency of supply. Nonetheless, various inefficiencies and inflexibilities in the processes for bringing new land and dwellings to the market have added to house price pressures, as have other increases in the costs of housing supply.

However, demand-side 'fundamentals' and constraints on supply arguably do not explain all of the recent growth in demand and house prices — especially in the past couple of years. In any asset price boom, rising prices can create expectations of further price increases unrelated to market fundamentals. That is, people may expect prices to continue growing strongly simply because they have done so in the recent past. Where prices are bid up further solely on the basis of such expectations, an asset price 'bubble' is said to exist.

As the submissions to this inquiry attest, there is a common perception that house prices in parts of Australia, or at least in particular market segments, have 'overshot' relative to the fundamentals, and that this has been responsible for some of the recent decline in affordability. There is also concern that, were this perceived bubble to burst rather than subside, an ensuing reduction in consumer spending and building construction would adversely affect economic activity and employment generally.

9.2 What is the evidence of 'overshooting'?

Features of the housing market make it prone to overshooting. Buying and selling houses is time-consuming and costly, making them much less liquid assets than bonds or equities. The enormous diversity in the housing stock means that markets for individual dwelling types in particular regions are typically quite thin. Also, as recent experience in the market for inner city apartments demonstrates, lags in the response of housing supply to a surge in demand mean that supply can continue to grow even after demand has abated.

Moreover, contemporary house price outcomes appear to have a strong conditioning effect on people's expectations about the future course of prices. For example,

surveys in the United States suggest that even after a boom has seen prices rise to very high levels, home buyers typically expect that prices will continue to grow strongly for another decade (Case et al. 2003).

A recent International Monetary Fund study (Bordo and Jeanne 2002) concluded that price booms in property markets were three times more likely to be followed by a bust than booms in equities markets. Two recent studies published by the Bank for International Settlements (Borio and McGuire (2004) and Tsatsaronis and Zhu (2004)), similarly pointed to the propensity for boom-bust behaviour in the housing market internationally.

As noted in chapter 2, downturns in the Australian market have most commonly manifested themselves in a stabilisation in nominal house prices leading to a fall in real prices due to the effects of inflation, rather than by significant and widespread declines in nominal prices. However, past experience highlights that nominal prices can fall appreciably — for example, according to Real Estate Institute of Australia data, the median detached house price in Sydney fell by 25 per cent in the two years following the end of the boom in the late 1980s. Indeed, with inflation now much lower in Australia than in the past, the sort of cyclical declines in nominal prices that have been common in some overseas countries, may become more frequent here.

Establishing the extent of any overshooting in the Australian housing market is very difficult. The 'true' value of a house at a point in time cannot be determined with much precision. Among other things, it will depend on the future value of the rental services provided to owner occupiers (implicitly) and investors (explicitly), the expected course of interest rates, and the rates of return available across the sweep of asset markets. These relative rates of return may in turn be influenced by taxation arrangements. Furthermore, it is difficult to distinguish between overshooting resulting from unrealistic price expectations, and short-term price surges before supply can adjust to a 'well-founded' increase in demand.

In the face of these problems, the use of econometric techniques to evaluate whether house prices are compatible with underlying fundamentals has not proved fruitful (chapter 4). Reflecting a widely held view, the Economist (2003) remarked that a 'bubble can never be positively identified until after it has burst'.

These 'identification difficulties' notwithstanding, in the Discussion Draft, the Commission set out several (investment-related) indicators of potential for a downward adjustment in Australian house prices, at least in real terms:

- Gross yields on investment in residential rental property — and thus implicit rental yields on owner-occupied housing — have fallen well below their

long-term averages in most of Australia's capital cities (see figure 2.5). While some decline in rental yields was to be expected given the fall in real interest rates, price-to-earnings ratios for houses relative to many other asset classes are well above historical norms.

- Yields on commercial property, where institutional rather than individual investors predominate, have remained at much higher levels and currently average 8 to 9 per cent (gross).
- Similarly, gross yields on residential rental property in some other 'comparable' countries appear to be much higher than in Australia (chapter 2).
- While trends in the availability and cost of rental accommodation vary considerably between locations and types of rental property, vacancy rates, especially for inner city apartments, have recently increased in some of the major cities. And, despite rising purchase prices, there is evidence that some landlords have had to reduce rents to find tenants for their properties. Moreover, with a large number of new inner city apartments likely to come onto the market in coming months, pressure on landlords will increase.
- Since the commencement of the recent price upswing, the ratio of median Australian house prices to average per capita income has grown by 50 per cent, and now appears to be high by international standards (section 2.3).

Also, in a discussion paper prepared for the CPA (2004), Professor Peter Abelson noted that (until recently) prices for apartments had risen by a similar amount to prices for detached homes, suggesting that this was 'unusual' given that the land requirement is much smaller for a high density dwelling. As noted in chapter 2, investors have been particularly active in the apartment market.

However, as the Discussion Draft pointed out, none of these indicators provides conclusive proof that prices have overshot. For example, greater rental yields on residential property in some other countries may partly result from regulatory controls and other market rigidities that limit private investment in those countries to high return properties. In forming a judgment on whether yields on residential property are high or low by international standards, returns on other asset classes in the countries concerned are also relevant.

And, the Commission's further analysis of returns in the commercial property market indicates that the decline in average gross yields in the past three or four years has been similar to that in the residential market. This suggests that the difference in yields between the two markets may well be a soundly-based outcome, rather than the result of irrational investment in residential property.

Tax considerations

Moreover, as some of those responding to the Discussion Draft emphasised, it is *after-tax* rather than gross returns that ultimately dictate investment behaviour. Hence, in comparing returns across asset classes within countries, as well as between countries, differences in tax treatment are yet another relevant consideration. In an Australian context, differences in tax treatment according to whether a property investment is undertaken by an individual, by a company, or by a superannuation fund, can make such analysis very difficult (chapter 5).

Notwithstanding such complexities, a number of inquiry participants argued that when account is taken of the combined impact of private investors' access to unrestricted negative gearing, capital works deductions for buildings, and the discounted rate of capital gains tax, current house price levels in Australia appear more reasonable. Thus, in discussions at the public hearings, Professor Cameron Rider from the Melbourne Law School, observed:

> There is a suggestion that the housing price increases [are the result of] some kind of, to use someone elses words, irrational exuberance, but when you look at the tax advantages here you might say people are being exuberantly rational because its a good deal. (trans., p. 382)

More specifically, Bassanese (2004) recently contended that, at current financing costs and rental yields, nominal price appreciation of less than 2 per cent a year would allow an investor borrowing the full amount of the purchase price of a house to break even — that is, to recoup the after-tax cost of the excess of expenses over rental income while holding the property. The calculation was based on estimates by the Reserve Bank of Australia (sub. 199, p. 48) of the out-of-pocket costs of holding a fully geared rental property.

However, such calculations do not refute claims that there has been bubble-like behaviour in at least some parts of the Australian housing market. In the first place, they ignore several emerging risks confronting heavily geared investors. In particular, with a lot more rental housing coming on stream, gross rental income for tenanted properties may well fall further. Also, with increasing vacancy rates in some market segments, the difficulty of finding suitable tenants is likely to increase, leading to longer periods where rental properties are untenanted.

Any such reductions in rental income will in turn push up holding costs. While this may not be a major problem for those investors with other sources of income, investors without such cover could be forced to sell at a time when the expected capital gains are not realisable. For investors with a large number of heavily geared properties, the financial consequences could be severe, even requiring the forced sale of the family home.

Whichever way additional holding costs are covered, the preceding discussion illustrates that heavily geared investors potentially have much more at stake than is assumed in calculations which abstract from the risks attaching to this form of investment. Indeed, 'holding cost' calculations that ignore important risks have been used by some property investment advisers to attract new investors with limited resources into the property market.

This is not to deny that when account is taken of the taxation regime applying to investment in residential property, the extent of any bubble in the Australian housing market may have been overstated in some quarters. In responding to the Discussion Draft, several participants from the property sector argued that housing market 'fundamentals' were still strong.

Nonetheless, these and other inquiry participants also pointed to particular locations and market segments where the sustainability of recent house price growth, and even current price levels, is problematic. Notably, there is already evidence of market cooling, particularly for apartments where highly geared investors have been the major source of recent demand and price pressures. Several proposed high density projects have been cancelled. Inner city apartment prices have recently fallen in Sydney, matching a trend evident for a much longer period in Melbourne (RBA 2004e, p. 26). And, the well publicised collapse of a high profile property marketing company which had been focussing its activities and advice in this area, has contributed to a recent decline in investor confidence (chapter 3).

But there is also growing evidence of a more general slow-down in the market:

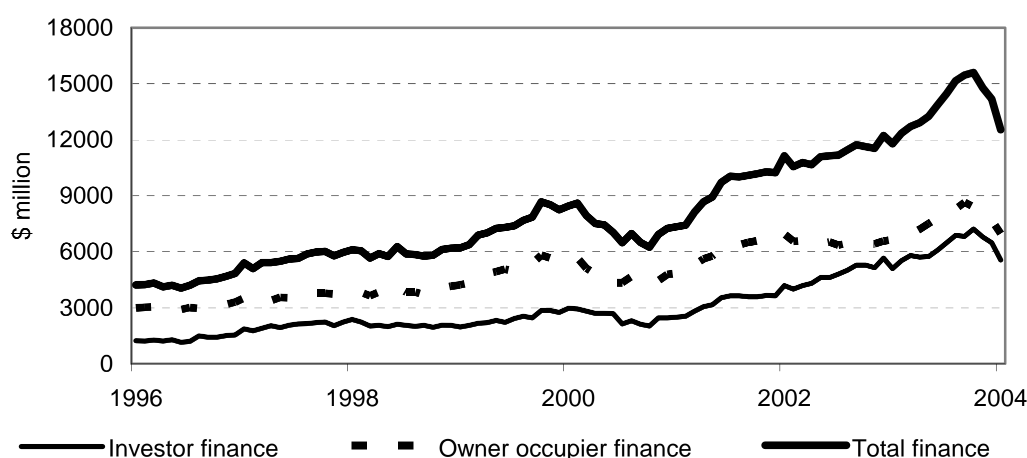
- New lending for both owner-occupied and investment dwellings appears to have peaked (see figure 9.2), with declines in lending since October 2003 ending the strong upward trend of the preceding three years.
- Auction clearance rates for established homes have fallen in a number of capital cities and there has now been a marked deceleration in average price growth in Sydney and Melbourne. As noted in chapter 2, sizeable price increases in these two markets heralded the beginning of the recent boom.

Also, in suggesting that the new housing market has peaked and is beginning to slow, the Master Builders Association (sub. DR256, p. 4) commented that '… the recent two increases in the cash rate will further temper any remaining exuberance'.

To summarise, an expectation of continuing appreciation in house prices, in combination with aspects of the taxation regime, appears to have driven recent market outcomes, and especially demand by investors. But realistic expectations about population and income growth cannot support a continuation of recent rates of price increase. Moreover, interest rates have now adjusted to the lower inflation

environment, meaning that there is unlikely to be a repeat of the structural surge in demand for housing driven by cheaper finance. While lower interest rates and more available housing finance are likely to sustain house prices at higher levels than before, a future softening of prices appears inevitable. However, the timing and extent of that softening is likely to vary across regional markets and dwelling types.

Figure 9.2 **Lending for the purchase or construction of dwellings**



Note. Seasonally adjusted. Excludes refinancing and financing for alterations and additions.

Data source: ABS (Lending Finance, Cat. no. 5671.0).

9.3 Implications for policy

Much of the increase in house prices during the recent boom is attributable to sustained growth in household incomes and cheaper and more accessible housing finance. Self evidently, these demand drivers should not be targets for 'remedial' policy intervention.

But income growth and financial market developments have not been the only causes of recent house price increases. Moreover, the effects of some of the other contributing factors have been exacerbated by inefficiencies in the housing market and in related policy settings. Hence, as previous chapters in this report have sought to establish, government policy initiatives can, over the *longer term*, help to promote more efficient and affordable housing outcomes:

- Initiatives to address structural factors that either encourage excessive demand for housing, or unnecessarily reduce the responsiveness of supply to increases in demand, will reduce 'average' house prices over the demand cycle and provide enduring affordability benefits to both home buyers and renters. As such, they

could help to narrow, though probably not eliminate, the gap that has long been evident in Australia between the trend increase in house prices and the growth in household disposable income.

- In addition, by increasing the responsiveness of supply or decreasing the amplitude of fluctuations in demand, some of these initiatives will reduce the volatility of house prices. This would mean that the benefits from acquiring a house would be less dependent on the time of purchase — reducing the risks attaching to both home ownership and investment in rental housing.

In previous chapters, the Commission has recommended several new policy initiatives, or endorsed current proposals, which could bring such benefits. These relate to the taxation of housing, land release and development approval processes, infrastructure charging and provision, and the regulation of home lenders and those providing investment advice to property investors.

However, the scope for governments to improve housing affordability in the *short term* is much more limited:

- In several of the policy areas noted above, the complexity of the issues involved and the need to address transitional concerns, means that further review is required before specific policy changes could be implemented. Possible modification to Australia's personal tax regime, which would have effects extending well beyond housing, is a case in point.
- Some initiatives to improve the responsiveness of housing supply — and especially any designed to increase the supply of housing land — could take several years to have a material impact on affordability outcomes.

Nonetheless, while recent interest rates rises and further price increases in some markets may lead to further declines in affordability in the short term, a more subdued housing market and continued income growth should in due course make it easier for prospective home buyers to enter the market.

Especially in a heated housing market, seeking to improve affordability through direct assistance to particular groups of home buyers also poses considerable challenges. Not the least of these is the likelihood that much of the benefit of such assistance is likely to be dissipated through ensuing increases in house prices. Even so, well targeted and appropriately configured support may allow *some* additional households to enter the market. Possible options for governments wishing to help more households achieve the goal of home ownership are the subject of the final chapter of this report.

10 A case for direct assistance measures?

Findings

- The case for providing direct financial assistance to foster home ownership is not strong.
- While conceived as compensation to first home buyers for the introduction of the GST, First Home Owner Scheme (FHOS) funding might provide a greater return to the community were it redirected to support the housing needs of low income households in rental, public or community housing.
- Many low income households, including in Indigenous communities, appear to be facing significant housing affordability problems. Their housing needs, and the nature and extent of assistance to help meet those needs, should be subject to a national public inquiry.
- If governments wish to continue to assist first home buyers directly, a scheme along the lines of the existing FHOS has attractions in terms of administrative simplicity and flexibility. But a greater impact on home ownership levels could be achieved if that assistance were better targeted at lower income households, with assistance rates commensurately increased.
  - Targeting would be best implemented by limiting support to those purchasing homes valued below regionally differentiated price ceilings.
- Any of the many other schemes put forward to encourage home ownership would also have to be targeted and provide substantial assistance to make any real difference to ownership levels. Most would involve more administrative complications than a better targeted FHOS.
- 'Shared-equity' arrangements of the sort considered by the recent Home Ownership Taskforce, would effectively allow for the purchase of part of a home and may therefore make 'ownership' more accessible for lower income households. The test of such arrangements is whether, once regulatory and tax uncertainties are overcome, the home lending market can develop products which are attractive to both borrowers and lenders.

The terms of reference ask the Commission to 'identify and examine mechanisms available to improve the ability of households, particularly low income households, to benefit from owner-occupied housing'. In particular, the Commission is asked to assess rent and direct ownership subsidies, loan guarantees and shared-equity initiatives.

Accordingly, this chapter examines possible rationales for providing assistance to foster home ownership, considers how much assistance would be appropriate, and assesses a range of possible measures for delivering it against relevant evaluation criteria.

In addressing these issues, the Commission has been cognisant that benefits for the community arise not only from home ownership, but also from access to affordable housing more generally. Hence, the chapter also discusses whether the community could benefit from the diversion of direct assistance currently provided to first home buyers to, for example, public housing and/or rent assistance for low income households.

10.1 Existing measures

First Home Owner Scheme (FHOS)

The main instrument providing direct assistance to first home buyers is the FHOS, introduced in July 2000 as an offset to the GST. The basic grant of $7000 is funded and administered by state and territory governments. Over the period from March 2001 to June 2002, the basic grant was supplemented by top-up grants funded by the Australian Government — the rationale for these was to provide additional support to the building construction industry.

By January 2004, the scheme had provided around $4.3 billion in assistance, including the top-up grants, to over half a million first home buyers. (More details on the scheme are provided in chapter 4.)

Other measures

All state and territory governments assist first home ownership through a range of stamp duty exemptions and concessions (chapter 5).

Most also provide a range of other support for housing purchases, including direct lending, deposit assistance, interest rate assistance, advisory and counselling services and mortgage relief. These programs are not all specifically targeted at first home buyers. But eligibility is often linked to income and other household characteristics and may require that applicants do not already own, or part own, a home or land.

As specific examples of these programs:

- HomeStart Finance in South Australia offers an ‘Advantage Loan’ of up to $165 000 to eligible home buyers.
- The Keystart Home Loan scheme in WA offers low deposit loans to low income earners who do not own or part own a home or land. Fee assistance of up to $2000 can be capitalised into the loan, which does not require mortgage insurance. Historically, the Keystart interest rate has been marginally lower than the standard variable rates offered by the major banks (BGC Residential, sub. DR292, p. 4).
- The Victorian Government provides mortgage interest relief of up to $15 000 over a maximum of two years for people who have experienced an unavoidable change in circumstances for which adequate preparations could not be made, and where mortgage repayments exceed 27 per cent of income.
- The Streets Ahead program in Tasmania offers a range of incentives to low to moderate income home buyers. Assistance may be provided in one or more forms, including deposit assistance, payment of transactions costs (such as stamp duty and mortgage insurance), prepayment of rates for the first year, contributions towards home improvements, and provision of advice on home finances or property condition. Also, Housing Tasmania’s Sales Program gives precedence to public housing tenants and others on low incomes when public housing properties are put up for sale (sub. DR320, pp. 19–20).

The states and territories also fund schemes designed to increase the availability of land and housing. For example, the Victorian Group Self Build program provides help for eligible groups of households to build or purchase new housing. And, in addition to provision of public housing, government-owned land development agencies operate in most jurisdictions alongside private developers to supply serviced residential building lots. Some of these agencies have affordability as well as commercial objectives:

- VicUrban is required by the Victorian Government to contribute to improvements in housing affordability in Victoria whilst undertaking its functions in a commercial manner (sub. 85, p. A3).
- The ACT Government’s Land Development Agency intends to make a proportion of its serviced land affordable to specific sectors of the market, such as first home buyers (sub. 204, p. 8).

10.2 Rationales for direct assistance to foster home ownership

As noted in chapter 1, generally acknowledged benefits such as increased social stability and better educational outcomes for children help to explain why governments in Australia provide considerable support for home ownership. However, that chapter points out that:

- affordable rental housing also provides social and distributional benefits;
- policies to assist home buyers must have regard to any costs imposed on those in private rental, public or other forms of community housing; and
- there are wider economic and social costs from promoting home ownership which must be included in the policy calculus.

Moreover, as ownership levels rise, some of the additional 'spillover' benefits for the community from subsidising home ownership will decline (possibly to very low levels). Conversely, the assistance required to achieve additional increments in home ownership will increase (possibly to very high levels).

The stated purpose of the FHOS, the largest budgetary program specifically designed to help first home buyers, is somewhat different. Its rationale is not to foster increased home ownership as such, but rather, as noted, to compensate first home buyers for the increase in housing prices associated with the introduction of the GST. Such compensatory measures are often employed by governments when new taxes are implemented.

As a compensation instrument, the FHOS is not particularly well targeted. In contrast to GST collections on new housing, which rise in proportion to prices, the FHOS grant is a flat $7000. Indeed, once the purchase price exceeds about $77 000, the grant becomes less than the notional GST (assuming full pass through of the tax into new house prices). Also, grants are paid to those purchasing existing dwellings. As discussed in chapter 5, the extent to which GST-related price increases for new dwellings have flowed through to prices for established dwellings is uncertain.

In the Commission's view, it therefore makes more sense to take the new tax regime as given, regard the FHOS as a form of assistance to encourage first home ownership, and assess the case for its retention in the longer term on the basis of the following two questions:

- Is the FHOS likely to have socially beneficial impacts on home ownership levels?

- Would funding for the scheme — whether termed GST 'compensation' or support for first home buyers — provide better returns to the community if it were spent in other ways?

A number of factors are relevant in this regard (and in considering other forms of direct government assistance to promote home ownership):

- While Australia's rate of home ownership has declined somewhat recently, it remains high by international standards (see table 2.3) and the large majority of people will own a home during their lifetimes. This suggests that there may be only limited scope for policy to increase the overall time spent in home ownership, as most people will prefer to rent at some stage in their lives.
- As well as direct assistance to first home buyers, Australian governments provide encouragement for home ownership over renting through the tax system (for example, the non-taxation of imputed rental income and exemptions from land tax and capital gains tax for the family home — see chapter 5).
- History suggests that a cyclical adjustment in home prices almost inevitably follows the sort of price rises of the past few years. Consequently, some of the recent sharp decline in affordability is likely to be reversed in the short to medium term. This will in itself facilitate home ownership, without the provision of more government assistance.

These considerations taken together suggest that the rationale for continuing to provide direct assistance specifically aimed at increasing home ownership levels is not strong. Further, as noted above, any direct support for first home ownership needs to be assessed against other possible programs to promote better housing outcomes and, ultimately, against uses for funds outside the housing sector. The issue of whether the current support provided through the FHOS and other direct assistance arrangements would provide a greater return to the community were it redirected into other measures to help meet the housing needs of low income Australians is particularly pertinent in this context.

10.3 Housing needs of low income households

A number of inquiry participants from the social welfare and union sectors considered that the housing needs of low income households require greater attention, especially those in public and private rental accommodation (see boxes 2.1 and 10.1). In this regard, reference was made to:

- declining levels of investment in public housing;
- inadequate supply of low cost private rental accommodation; and

- growing affordability problems facing Commonwealth Rent Assistance (CRA) recipients.

Moreover, two submissions devoted special attention to perceived inadequacies in the extent to which the housing needs of low income Indigenous households were being met (see box 10.2).

Box 10.1 **Participants' comments on the housing needs of low income households**

Australian Council of Social Service

> Demand for low cost [public and private] rental housing is rising at a time when investment in such provision has fallen to an all time low. (sub. 147, p. 6)
>
> The Commonwealth Rent Assistance program … is … increasingly being found to be inadequate in delivering affordability, especially in capital cities and other locations where jobs are more plentiful. (sub. 147, pp. 6–7)

Construction, Forestry, Mining and Energy Union, Construction & General Division

> The Union believes that Australia is in the grip of a housing crisis. This crisis is not only characterised by declining affordability in first home ownership, but by increasing levels of housing stress among low to middle income participants in the private rental market, the degradation and running down of public housing stock across Australia, and finally, by growing levels of homelessness in the community. (sub. DR255, p. 2)

National Shelter

> Unfortunately, there is now ample evidence indicating that there is a grossly inadequate supply of affordable rental housing at the bottom end of the market. (sub. 157, p. 8)

Victorian Government

> A key concern of the Victorian Government … is the supply and cost of suitable rental accommodation for low income earners. As a matter of policy, the price of public rental is set at levels which are affordable. Despite additional action by the Victorian Government, real funding reductions under the Commonwealth–State Housing Agreement have prevented public housing supply keeping pace with the growth in the eligible population. (sub. 85, p. 10)

Queensland Shelter

> All three regions surveyed by Queensland Shelter reported a serious decline in housing stock at the affordable end of the rental market. This translates into an overwhelming demand for housing assistance in the State. (sub. DR247, p. 3)

Brotherhood of St Laurence

> More households are now spending longer periods in the private rental market, but the market has failed to respond to this increased demand with an increased supply of affordable housing. In addition, the supply of public housing has not kept pace with demand and existing stock now has to be targeted to the most disadvantaged households — those in receipt of income support and with barriers to participation in the labour market. (sub. 211, p. 2)

Box 10.2 **Housing needs of Indigenous people**

Northern Territory Government

Surveys and censuses over the past decade have shown that Indigenous households are twice as likely as other Australian households to be in need of housing assistance. The data also shows that Indigenous people experience high rates of (before and after) housing poverty, homelessness, overcrowding, and lack of adequate standard of housing, infrastructure and basic services. These poor living environments are factors that contribute to and exacerbate Indigenous people's poor health. Addressing this continuing high level of unmet need is a key issue for the Territory in delivering affordable housing.

Unmet housing need in Indigenous communities is estimated to be $2 billion nationally, of which the Territory has an outstanding need of over $800 million. Demographic projections point to a further explosion of housing need in Indigenous communities over the medium to long term, exacerbated by the youthful profile of the population. In Wadeye, for example, where the current occupancy rate is 14 people per household, a further 144 dwellings will be needed by 2023 to maintain the existing occupancy rate. An additional 448 dwellings would be required to 'normalise' occupancy rates. Any consideration of home ownership affordability should be considered in the context of this unmet need. (sub. 197, pp. 2–3)

Aboriginal and Torres Strait Islander Commission (ATSIC)

The success of ATSIC's Home Ownership Program suggests that mainstream lenders could consider adjusting their lending policies and practices to accommodate the needs of first home buyers, without jeopardising the overall integrity of their loan portfolios.

ATSIC has found that by removing impediments to home ownership for low income earners that rates of repayment are similar to those which are achieved by mainstream lenders, and that the rate of account delinquency compares more than favourably when compared to commercial lending portfolios.

For many reasons … Indigenous Australians have not been able to participate in home ownership at the levels enjoyed by the broader Australian community. Currently less than 32 per cent of Indigenous Australians participate in home ownership compared to around 72 per cent for the wider Australian population.

Disparity in home ownership participation by Indigenous people is of particular concern to ATSIC because of the significant positive correlation that exists between home ownership and social and economic participation. Various studies have highlighted that home ownership is associated with a higher probability of mainstream employment, and a lower probability of criminal charges and family violence within the Indigenous population, both of which are key areas of government intervention for improved outcomes for the Indigenous population. (sub. 149, pp. 2–3)

Various ways to address these problems were canvassed by participants. There were calls for large increases in government funding for public housing through the Commonwealth–State Housing Agreements — for example from NCOSS and Shelter NSW (sub. DR257) and the CFMEU (sub. DR255). As well, there were requests for changes to enhance the CRA, with ACOSS (sub. 147) and National Shelter (sub. 157) proposing that eligibility be extended and that it be modified to take account of variations in rent levels across Australia.

Further, several participants called for government initiatives to stimulate private investment in affordable rental housing, to cater for low income households that currently are ineligible for public housing and rental assistance. In this context, there was reference to financing mechanisms proposed in a recent report prepared by the Allen Consulting Group for the Brotherhood of St Laurence, the Committee for Economic Development of Australia, Melbourne Affordable Housing and VicUrban (see box 10.3). As discussed later, some of these mechanisms could also potentially be used to finance schemes that explicitly seek to increase home ownership levels.

Box 10.3 **Stimulating private investment in affordable housing**

A recent report by the Allen Consulting Group considered the advantages and disadvantages of three options to increase private sector investment in affordable housing. Each would be dependent on government subsidies to leverage 'large volumes' of private finance to expand the supply of affordable housing. The three options were:

- the Bonds Model — government investment in affordable housing financed by government bonds, supplemented by a recurrent government subsidy;
- the Partnerships Model — private sector investment in affordable housing financed by private equity and/or debt investment, supplemented by a flexible government capital grant or recurrent subsidy; and
- the Tax Credits Model — private sector investment in affordable housing financed by private equity and/or debt investment, supplemented by a fixed recurrent subsidy delivered through a tax credit.

The report noted that each of the models examined has advantages and disadvantages and concluded that 'no single model is likely to produce the best outcome on all [assessment] criteria'.

Source: Allen Consulting 2004, p. vii.

In submitting such proposals to an inquiry on the affordability of home ownership, several participants argued that there was a strong link between assistance for low income public and private rental housing, and first home ownership. They contended that such assistance can help tenants save for a housing deposit and, by increasing the number of low cost houses, moderate price pressures in the market more generally.

However, while there is no doubt that such links exist, their strength is doubtful. For example, public rental dwellings comprise only around 5 per cent of Australia's housing stock (ABS 2001 Census data), with only a minority of public housing tenants subsequently purchasing their own homes. In any case, although flow-on

ownership effects are a relevant consideration in formulating policies to help meet the housing needs of low income households, the case for assisting those households through public housing, rental subsidies or other measures does not hinge on those effects. Of more importance are the nature and extent of these housing needs, and how these are most effectively addressed.

These are complex issues which the Commission has not been in a position to evaluate during this inquiry. Moreover, the information base in this area is far from comprehensive and sometimes conflicting, making it difficult to judge whether the problems confronting low income households have worsened substantially during the recent price upswing. Nevertheless, housing affordability is clearly a significant problem for many low income households.

A 'National Affordable Housing Project' (NAHP) is working under the auspices of the Commonwealth–State Housing Ministers Council to promote 'a national, strategic, integrated and long-term vision for affordable housing in Australia, through a comprehensive approach by all levels of government' (Victorian Government, sub. 85, p. A4). Possible ways to better meet the housing needs of low income households were also canvassed as part of a recent Senate Inquiry into poverty and financial hardship (Senate Community Affairs References Committee 2004).

But it is now more than a decade since the last independent national review of these issues (see box 10.4). The Commission considers that the time is now right to conduct a similar review encompassing the full range of affordability issues raised by participants to this inquiry. Such an inquiry could both draw on and help inform the work currently in train under the NAHP.

RECOMMENDATION 10.1

A national public inquiry should be established to examine the housing needs of low income households across Australia, including in Indigenous communities, and the nature and extent of assistance to help meet those needs.

10.4 Criteria for assessing assistance measures

In the Commission's view, as discussed above, the case for direct assistance specifically aimed at increasing levels of home ownership is not strong. This of course does not negate the case for broader policy changes (discussed in earlier chapters) that might facilitate home ownership — such as reducing reliance on stamp duties in favour of more efficient taxes, and improving the efficiency of land

supply. However, they should be pursued for their broader efficiency and equity benefits, rather than simply because they could increase ownership levels.

Box 10.4 **The Industry Commission's report on public housing**

In 1993, the Industry Commission undertook a detailed inquiry into the effectiveness and efficiency of the delivery of public housing and rental assistance. The inquiry found that public housing was a cost effective way of meeting government housing objectives, to be used as part of a mix of assistance measures also likely to include rent assistance, community housing and leasing of a property by a housing authority or community group (for on-leasing to a tenant).

The Industry Commission did not come to a view on the appropriate level of funding, seeing welfare priorities as an issue for governments, although it noted that the inquiry findings pointed to many areas of unmet need. Based on the assumption that funding constraints are inevitable, the Industry Commission called for better targeting of public housing and rent assistance.

Amongst other things, it recommended that rent assistance be extended to all low income tenants in the private rental market (rather than only recipients of welfare payments) and pointed to inequities stemming from the cap on rent assistance, with people who pay higher rents in some regions receiving the same level of assistance as those renting in low cost regions. The report also commented that the private rental market tended not to provide enough affordable dwellings for those on low incomes and was 'slow to respond to changes in demand at the low cost end'.

Since the inquiry, there has been a move to greater targeting of public housing assistance to applicants in greatest housing need in line with the Industry Commission's recommendations. Governments have continued to provide a mix of assistance including public housing, community housing and rental assistance. The Australian Government has also extended eligibility for Commonwealth Rental Assistance, with funding increasing significantly in real terms since 1993.

Source: Industry Commission (1993b).

Nevertheless, *if* governments wished to continue providing explicit assistance to first home buyers, then a number of criteria provide guidance on approaches that are likely to deliver the highest payoff for the community. These relate to effectiveness, flexibility, administrative costs and distributional outcomes.

Effectiveness

In accord with the perceived social benefits of home ownership, the objective of specific assistance should be to maximise the increase in home ownership for any given level of funding.

Such support can potentially increase home ownership — and thereby the social benefits that accrue to the community — in two ways. First, for families that would be able in time to purchase their first house without assistance, government support can bring that purchase forward. Second, it can bring home ownership within the reach of those who might otherwise never be able to purchase a home.

If most of the assistance supporting first home buyers were to go to those families who would otherwise be able to purchase within a relatively short period of time, the incremental social benefits to the community of that assistance would clearly be limited. Hence, better value from assistance should be obtained if it is targeted at lower income households who otherwise may not be able to purchase a home, or whose purchase would be considerably delayed.

Flexibility

The characteristics, resources and aspirations of households vary. Therefore, a desirable attribute of direct assistance measures is flexibility for households to choose the standard and type of housing services they wish to purchase. Untied grants, for example, enable households to pick the housing that best suits their needs and preferences, within their available means. Some households may be prepared to sacrifice other spending to live in a larger house or in a particular neighbourhood.

Obviously, for those struggling to purchase a first home, choices may be very limited, in terms of the prices they can afford to pay, or the areas in which they can afford to purchase (chapter 2). Nevertheless, even in an environment of constrained choice, providing flexibility to recipients as to how they use assistance will still be beneficial.

Administrative costs

It is important to keep administrative and compliance costs as low as possible, consistent with the achievement of program objectives. Indeed, care needs to be taken that such costs do not outweigh the benefits of the assistance program from promoting greater home ownership. Thus, some tradeoff between administrative costs and other program design criteria — especially targeting — may need to be made.

Demand-side or supply-side?

Measures to assist first home buyers can be broadly grouped into two categories: those that seek to boost purchasing power (demand-side approaches) and those that seek to increase the supply of affordable land and housing (supply-side approaches).

Either approach, if well designed, can help aspiring first home buyers. Schemes in either category can also have similar flow-on distributional effects in the broader housing market:

- Measures that increase purchasing power will tend to increase house prices, particularly if there is limited capacity to augment supply in response to the ensuing increase in demand. This will benefit existing home owners at the expense of those seeking to purchase, including first home buyers — though recipients of assistance will still be better off overall. In the longer term, this price impact may be lessened as higher demand resulting from the increase in purchasing power stimulates an increase in the supply of housing.
- Similarly, subsidising the provision of housing for particular groups of home buyers during a period of supply constraint (of land and builders) may push up house prices generally. That is, such subsidies may again add to overall spending on housing in an environment where the number and quality of dwellings cannot be readily expanded. Thus, while those assisted will be better off, this could come at the expense of other home buyers. However, here also, any price raising effect will tend to be reduced over the longer term as supply expands in response to increased demand.

As discussed in chapter 6, measures which free up land supply for housing can improve affordability for all home purchasers, including first home buyers. But these are long-term approaches, and cannot readily address the short-term affordability problems currently confronting aspiring first home buyers, especially as new dwellings can augment the housing stock only slowly.

Weighing up

Especially in the short to medium term, all assistance measures aimed at helping first home buyers are likely to have flow-on effects that will dilute the benefits for recipients and adversely affect other home buyers. In particular, during periods of strong demand for housing and with inelastic supply in the short term, such measures will tend to push up house prices across the market. From this viewpoint, there may be little to choose between demand-side and supply-side approaches on distributional grounds.

Given this, and in the light of the program-specific evaluation criteria outlined above, the choice of measures hinges on the scope to target support at lower income households, while preserving flexibility and keeping administrative costs as low as possible.

In the Commission's view, demand-side measures will *generally* offer a better balance in these respects, especially where the goal is simply to enhance home ownership in the broad.

Supply-side measures may sometimes be preferable in assisting subgroups of potential home buyers with very specific needs, especially where those needs are not readily accommodated in the market — for example, housing for those with disabilities. Indeed, there are several supply-side schemes in place to cater for such specific needs, including some mentioned above in section 10.1.

However, the intrinsically more prescriptive nature of supply-side measures weighs against their use in delivering assistance on a larger scale. As discussed later in the chapter with reference to some specific proposals, the likelihood of higher administrative costs per dollar of support provided, and reduced flexibility for assistance recipients, are germane in this regard. Hence, the primary focus in the following discussion of the advantages and disadvantages of different assistance mechanisms is on demand-side approaches.

Given the number of different approaches canvassed by participants in this inquiry and in other recent reports, and the overlaps between many of these approaches, this discussion concentrates on broad outcomes, and abstracts from many of the implementation issues that could affect detailed outcomes.

However, a more extensive treatment of the FHOS is provided, because that is currently the major budgetary mechanism providing support to first home buyers, and was the focus of much of the commentary from participants. Thus in the following discussion, the FHOS, in its current or modified form, is used as a benchmark against which to assess other proposals. In keeping with the emphasis in the terms of reference, a more extended analysis is also provided for the shared equity and housing lifeline arrangements that were discussed during the recent Home Ownership Taskforce deliberations.

10.5 Modifying the First Home Owner Scheme

As discussed above, in the Commission's view, it makes more sense to look at the case for retaining the FHOS over the longer term, on the basis of its impacts on home ownership, rather than in relation to whether ongoing compensation for the

GST can be justified. Importantly, the FHOS has some basic characteristics that would be desirable in any ongoing assistance scheme for first home buyers:

- it is relatively simple and cheap to administer; and
- because grants are not tied to the type of dwelling or to location, it provides flexibility for families to purchase houses that best suit their needs and preferences.

However, a deficiency in the present arrangements is their lack of targeting. The bulk of assistance goes to families who might otherwise have purchased a house before too long, even without assistance (see box 10.5). In NSW, for example, 14 per cent of grants go to purchasers of homes priced above $500 000 (see below). Together with the small size of the grant relative to house prices, this lack of targeting means that, in its current form, the FHOS is unlikely to offer much help to low income households. This in turn suggests that if the FHOS is to be retained, better targeting would be desirable.

The Commission notes that, conceptually, stamp duty concessions and the FHOS are effectively alternative ways of providing subsidies to first home buyers. From this viewpoint, there might well be some administrative savings if one of these two measures were discontinued, with assistance provided solely through the other. However, in most jurisdictions, the FHOS provides higher funding than required to enable the complete removal of stamp duties currently paid by first home buyers. Accordingly, the following discussion looks at ways that the FHOS could be better targeted on the assumption that a dedicated scheme of this sort is retained.

Better targeting

Many inquiry participants supported the view expressed by the Commission in the Discussion Draft that higher returns to the community would accrue from the FHOS were it targeted more directly to potential first home buyers on lower incomes. As an example, the NSW Government stated that it:

> … endorses tightening eligibility for the First Home Owners Scheme (FHOS). This would improve the equity of the grant while minimising its impact on overall demand and property prices. In addition, the NSW Government supports allocating savings from tightening FHOS eligibility to increased targeted relief for first home buyers. (sub. DR315, p. 1)

The targeting options put forward included placing a ceiling on property values and/or basing eligibility on income and asset tests. For example, the WA Government has already proposed an effective capping to property values of $500 000 (sub. DR339, p. 3). The Victorian Government (sub. DR301, p. 1) and the

AWU (sub. DR290, p. 2) also both proposed a cut-off of $500 000, with the AWU further proposing that an annual income cap of $80 000 apply. In addition, there were proposals for the amount of the grant to be substantially increased (see box 10.6), as well as a suggestion from the NSW Government that, alternatively, 'savings' from better targeting could be used to enhance stamp duty concessions for first home buyers (sub. DR315, p. 8).

Box 10.5 **Views on the 'pull-forward' impact of the FHOS**

Participants generally supported the view that the main effect of the FHOS has been to pull forward home purchases by those already capable of achieving home ownership in the *short term*, rather than significantly increasing the number of households with a realistic prospect of becoming home owners.

Even so, there were suggestions that this effect could be substantial. For example, Professor Ross Guest (sub. 128) submitted the results of simulation analysis, which have been interpreted by some as indicating that FHOS assistance will bring forward home purchase decisions by as much as five years on average. Thus, in drawing on this analysis, the Housing Industry Association submitted:

> On the basis of the estimate that on average FHOG [the grant] brought forward the move into home ownership by five years for some 500 000 people, this represents an increase of around 2.5 million years of home ownership for Australians. Even if the marginal social benefits of home ownership are very small, the total benefits for Australia of all this additional time spent as home owners would be staggering. (sub. DR260, p. 32)

But when viewed in the context of the total number of years that most people will own a home over their lifetimes, the social benefits that would accrue from an increment of five years assume less significance.

More importantly, the methodology employed by Professor Guest means that the projected pull-forward effect of five years is likely to greatly overstate the actual pull-forward impact. In effect, the methodology means that the smallest pull-forward outcome that can be projected is five years, irrespective of funding levels, grant rates etc.

Indeed, were a grant of just $7000 capable of pulling forward demand by five years on average, it suggests that the average home buyer is only saving around $1400 a year towards a housing deposit. However, most potential first home buyers evidently save much more than this — with savings of just $1400 a year, it would take the average household currently renting their accommodation nearly 15 years to accumulate the deposit required for a $200 000 home.

Especially in light of these responses to the Discussion Draft, the Commission considers that, if the FHOS is to continue for any length of time, some form of targeting should be implemented. Better targeting offers the potential to free-up funds to increase the level of the grant — indeed, to make a real difference to low income households, it is likely that a larger grant would be needed (see below). Of

course, targeting raises some important administrative issues that will be relevant in choosing between specific approaches that seek to focus support on lower income home buyers. Further, at least in theory, substantially increasing the level of grants could reduce the incentive for potential recipients to save for a housing deposit.

Box 10.6 **Suggested modifications to the FHOS**

Several modifications to the FHOS were suggested by inquiry participants, including:

- *Applying a means test, or both means and assets tests* — aimed at restricting eligibility to households with incomes (and/or assets) below specified thresholds. Thresholds could be differentiated to reflect geographical variation in average income levels.
- *Adjusting the value of the grant according to income* — similar to means testing, but with the value of the grant linked to household income. Households with low incomes would receive a higher grant than households with higher incomes.
- *Placing a cap on the value of the home* — designed to limit eligibility to those households building or purchasing a home under a specified maximum value. That value could be linked to the median house price.
- *Indexing the value of the grant to median house prices* — involving regular adjustment of the value of the grant in accordance with movements in median house prices. This could be a national, state or regional index.

Ceiling on property values

Evidently, the effect of a price ceiling in better targeting support would depend on the level of that ceiling. For example, the NSW Government indicated that restricting eligibility for FHOS support to the purchase of NSW properties worth less than $1 million would only have reduced the number of grants by about 1 per cent annually and saved less than $3 million (sub. DR315, p. 6). But, with caps of $700 000 and $500 000, the respective savings would have been $11 million (4 per cent) and $39 million (14 per cent).

Further, the impacts would depend on whether ceilings were locationally differentiated in line with regional variations in house prices. Information provided by the SA Government, for instance, suggests that, in contrast to NSW, a home price cap for that state of around $500 000 would have produced a 'saving' of only around $1 million over the three years — much less than 1 per cent of total FHOS grants to SA home buyers over that period.

More generally, as the price of the home purchased does not precisely correlate with a household's income levels or assistance needs, a price ceiling approach would be

a somewhat blunt way of targeting support at those most in need. Nevertheless, it could be an administratively cheap option for directing available funds in a way which is more likely to enhance home ownership levels than untargeted assistance.

Income and asset tests

In principle, providing assistance on the basis of a household's available income and assets would better target support to lower income households. However, implementing effective income and/or asset testing would be problematic, a point made by the Victorian Government in its response to the Discussion Draft (sub. DR301, p. 5). The NSW Government similarly noted that an income test on an assistance arrangement it had operated until 2000 was abolished 'because of concerns that an income tax assessment and/or group certificate was not always an accurate record of a person's actual income' (sub. DR315, p. 7).

Moreover, to avoid providing assistance to income poor but asset rich households, levels of income and assets should ideally both be subject to examination. But experience with income and assets tests illustrates the difficulty of assessing income and assets in a consistent way across households. Unless the tests are carefully designed, they may create incentives for some households to lessen their declared income or assets in order to qualify for assistance. The interaction with other income-tested benefits available to low income households would also need to be considered. And, like a cap on house prices, income and assets test ceilings may need to vary regionally, given the variation in house prices. This would raise further equity and administrative problems.

At the very least, subjecting FHOS grants to income and assets tests is likely to be administratively expensive, compared with the alternative approach of targeting through limiting support to those purchasing homes below a designated price ceiling. Indeed, the Tasmanian Government argued that the administrative difficulties associated with income and asset tests would be so serious that they could negate any benefit from better targeting:

> … attempting to replace the present relatively straightforward, consistent and administratively simple scheme with an expensive, convoluted model would offer only a dubious improvement in the equity of its outcomes. (sub. DR320, p. 9)

Increasing the size of the grant

Leaving administrative difficulties aside, both of the above approaches would better target assistance to low income households. However, it is unlikely that either would be effective in promoting increased home ownership among such households unless the size of grant were increased substantially. Grant assistance will be the

main monetary resource available to many low income families to pay a housing deposit, with the current $7000 grant falling well short of the standard deposit required on even very low value properties in most parts of Australia.

Conclusion

If the FHOS is to continue for any length of time, the Commission considers that the case for targeting support to lower income households is compelling. In its view, however, income and assets tests are likely to be administratively expensive and cumbersome and possibly an ineffective way of implementing this objective. The Commission's preference would instead be to limit eligibility for FHOS support to those purchasing homes priced below regionally differentiated price ceilings. These ceilings could be adjusted from time to time in line with changes in house prices generally.

Further, targeting of assistance offers the opportunity to increase the average level of grant without increasing overall funding requirements. Indeed, the Commission reiterates that grant levels would need to be substantially increased if the FHOS is to make a significant difference to home ownership levels among lower income households.

RECOMMENDATION 10.2

If the First Home Owner Scheme continues:

- ***assistance should be targeted to the housing needs of lower income households by restricting eligibility to homes below (regionally differentiated) price ceilings; and***
- ***there should be a commensurate increase in the average size of the grant.***

The Commission notes that amendment to the current FHOS, which was established under the auspices of the Intergovernmental Agreement (IGA) on Federal–State Relations 2000, would require negotiation and agreement between governments. The NSW Government was concerned to ensure that any 'savings' generated by tightening of FHOS eligibility 'are returned to NSW first home buyers and are not retained by the Commonwealth Government' (sub. DR315, p. 8). The Commission therefore suggests that, if the FHOS is to continue, the implementation of price ceilings and increase in grant levels be taken up by governments in the context of the IGA.

Those considerations should also have regard to the Commission's view that the case for providing assistance explicitly directed at increasing home ownership levels is not strong, and that diverting some or all of that assistance into other

measures to help low income households may well provide a better return to the community. The Commission's proposed national public review of how best to meet the housing needs of low income households — both renters and home buyers — could help to inform discussions within the IGA on the future role and configuration of the FHOS.

10.6 Other possible measures to facilitate home ownership

As noted, a variety of other approaches to assist first home buyers were canvassed by inquiry participants or have been raised in recent reports looking at housing affordability issues.

Like the FHOS, most of the these arrangements could be targeted to low income households. Moreover, some have areas of overlap or commonality with mechanisms to increase the access of low income households to affordable rental housing and are thus relevant in a wider affordability context. However, the following assessments focus on their capacity to increase home ownership.

Encouraging saving

While there are many possible ways to encourage saving, one proposal suggested in a recent report by the Allen Consulting Group (2003) prepared for the Chifley Research Centre, involves the government or other entities matching savings by low income households through grant payments. Among the possible uses for the accumulated savings would be the payment of housing deposits or mortgage repayments. Similarly, the ANZ Bank proposed that the Australian Government adopt special savings accounts, like those available in the United States and the United Kingdom, which are given concessional tax treatment when accumulated savings are used for a home deposit (sub. 193, p. 9).

However, the international evidence is mixed on whether savings subsidies have any appreciable effect on overall savings levels. The impact will partly depend on whether households can qualify for a subsidy simply by switching funds from other savings. Also, some households might just substitute the government subsidy for their own savings. In any case, many low income households have little capacity to save.

These observations suggest that, unless carefully designed and targeted, such schemes may have very little impact on home ownership rates. They may merely enable those who otherwise could afford to purchase a house to either reduce their

own savings and increase their consumption of other goods and services, to bring forward their time of house purchase to some extent, or to buy a more expensive house.

As previously discussed, such problems also arise under the FHOS. Indeed, conceptually, the FHOS can be likened to a savings investment scheme, with the subsidy paid at the end of the savings period (at time of house purchase) to add to the saving already made by the household for a house deposit, rather than paid during the savings period. However, the FHOS appears simpler to administer. For example, inflows in and out of savings investment accounts would need to be monitored and payments made over a number of years, compared with a once only payment under the FHOS.

Access to own superannuation

Several participants suggested that potential first home buyers should be able either to access loans against, or to make early withdrawals from, 'equity' in their superannuation funds.

Such loans or withdrawals would help to offset any reduction, caused by superannuation contributions, in the saving otherwise available to a household to purchase its first home. However, for households with the capacity to borrow sufficient amounts for a housing deposit from the usual commercial sources of housing finance, early access to superannuation savings would effectively provide an alternative, rather than an additional, source of funds. Further, many of the low income households currently unable to borrow to purchase would have little superannuation from which to draw.

Moreover, were such access to be allowed, consideration would need to be given to relevant taxation arrangements, including those applying to early withdrawal and any subsequent repayment. Early access would effectively turn superannuation savings into a special savings account for first home buyers. Under current tax arrangements, this could offer more generous 'assistance' than the type of arrangement discussed in the previous section.

In addition to tax complications, the arrangement could have consequences for social security. It is possible that allowing such access could reduce the amount of financial saving available for retirement — depending on whether the funds were repaid, and the interest rate charged, and on whether the prospect of early access to purchase a home made savings more attractive generally. Were such a scheme introduced, saving accumulated at pension age may be more concentrated in the main residence, the value of which is currently exempt from the pension assets test.

However, if the scheme encouraged earlier home ownership, and if earlier home ownership in turn encouraged saving generally, then rent assistance and pension payments may be thereby reduced.

Sharing the benefits of public expenditure savings

A somewhat different 'savings-type' mechanism to assist low income households achieve home ownership is the 'home credit fund' suggested by Professor Gavin Wood (sub. 131, p. 6). This scheme is designed to encourage people on long-term welfare to move into employment by giving them a share in the resulting public expenditure savings. This share would be 'credited' to a trust fund that could be drawn upon to meet deposit requirements or mortgage repayments. To qualify, recipients would need to remain in employment for at least two years.

However, this would be a rather oblique way of encouraging home ownership. In the Commission's view, if greater home ownership is to be pursued, it is better to do so as directly as possible, thus maximising the likelihood of success while minimising administrative costs. Viewed in this light, the other ways of encouraging savings discussed above are likely to be superior.

It would also be possible to use the CRA mechanism in a similar way to the home credit fund approach. In a sense, CRA already operates to facilitate home ownership by increasing the capacity of recipients to save a deposit. This role could be extended by, for example, continuing to pay recipients *some* of the previous subsidy after they had purchased a home. However, this would render CRA little different from other explicit subsidies to encourage home ownership. In effect, eligibility for CRA would simply become the de-facto means test for targeting support.

Reducing deposit or repayment requirements

Caplin, Joye proposal for a shared-equity arrangement

A 'shared-equity' arrangement would enable a household to purchase a part-share in a dwelling, with the remaining part-owned by an investing partner. In Australia, some types of shared-equity schemes are offered by state and territory government housing authorities. For example, the WA Government enables public housing tenants to purchase between 70 and 100 per cent equity in their rental property under the GoodStart program (sub. 190, p. 51). As well, shared-equity lending products are now being canvassed by some private lenders.

Such shared-equity arrangements are different in nature to other arrangements designed to foster home ownership. In particular, by reducing the degree of equity achieved on purchase, they 'automatically' reduce deposit and repayment requirements compared to full ownership, without necessarily calling for government subsidy.

One shared-equity proposal that has received considerable recent attention is the model proposed by Caplin, Joye et al., in a report commissioned by the Menzies Research Centre for the Home Ownership Taskforce. Under this proposal:

> … housing would be financed with both a mortgage and a passive institutional partner who contributes equity capital to the dwelling in exchange for a share of the ultimate sale proceeds, with no other monetary payments made between the parties. (2003, p. 57)

The Caplin–Joye proposal would allow the householder to maintain control over the management of the property, with the benefit for the financier dependent on the nature of the equity arrangement with the occupant. Under a fixed contract, the investor would receive a fixed percentage of the final sale proceeds. With a flexible arrangement, the investor would receive different percentages depending on whether the price of the house had risen or fallen.

Whether or not such shared-equity arrangements would be attractive to borrowers and lenders is as yet uncertain:

- Some have suggested that, notwithstanding the lower cost of market entry, many potential borrowers would shun an arrangement where they only received a proportion of the proceeds when the house was subsequently sold.
- As equity investors, lenders would want to purchase homes in areas offering the highest returns. In recent years, the highest returns have typically been in more expensive suburbs (chapter 2). Conversely, low income home buyers would typically be looking to purchase in cheaper suburbs, even if their initial deposit and ongoing mortgage repayments were reduced through the shared-equity arrangement.
- And, although lenders would become an equity partner in the house, that would be without the control over the management of the property that an equity share usually brings.

Ultimately, the general 'test' of the viability of such arrangements is whether the home lending market can develop products which are attractive to both borrowers (particularly low income households) and lenders. As noted above, there are indications of some developing interest by financiers in shared-equity arrangements.

However, some have argued that there are regulatory and other impediments to the uptake of such schemes. Caplin, Joye et al. (2003, p. 27) noted that, while the introduction of shared-equity products can be accommodated within existing legal and regulatory frameworks, clarification is needed about whether the investor's gain would be taxed on a cash or accruals basis (that is, periodically or upon realisation of the capital gain). And the Australian Bankers' Association (sub. 164, p. 15) stated that a 'critical factor' is how the Australian Prudential Regulatory Authority would set capital charges for deposit taking institutions holding shared-equity investments on their balance sheets. To the extent that such regulatory uncertainties exist, clarification by the relevant authorities would obviously be desirable.

Also, regulatory uncertainties may not be the only impediment to the continuing development of shared-equity products. For example, the Australian Bankers' Association (sub. 164, p. 15) submitted that the viability of shared-equity products hinges on the creation of a sufficiently large portfolio of shared-equity investments to enable the development of a secondary market for the assets. It suggested that government has a role to play in facilitating the development of such a portfolio. It is implicit in this view that such arrangements might not be viable without start-up money or ongoing support from government.

The justification for any such government financial support, either start-up or ongoing, would need careful analysis drawing on the same evaluation criteria used above to assess the merits of other forms of support for first home buyers. It may be that some relatively modest funding might be sufficient to 'kick start' a reasonably wide range of shared-equity lending products. But, in the Commission's view, were more substantial support required, the case for government intervention through this instrument rather than through, say, a modified FHOS, would become much more questionable. In particular, the complexity of such arrangements could make appropriate targeting of government support difficult. And administrative costs per dollar of assistance provided could also be high relative to some of the alternative approaches discussed above. Hence, the Commission considers that the further development of shared-equity products should essentially be determined by their attractiveness to borrowers and lenders, subject to clarification of the taxation and prudential issues noted above.

An alternative shared-equity approach was examined in another report for the recent Home Ownership Taskforce (Gans and King 2003). It would enable a household to purchase a home from a government or private investor who would retain ownership of the land on which the dwelling is sited. To a large extent, the issues raised by this approach are the same as those arising under the Caplin–Joye scheme. However, there would be the additional complexity created by the need to separately value the land and the buildings.

Keystart and similar programs

A number of existing programs, such as the WA Keystart program and programs run through the Housing Societies and Mortgage Managers Association in Victoria, offer housing finance to low income households. Finance might be provided with lower deposit requirements, at lower interest rates, or without the mortgage insurance required in accessing normal commercial finance, with any cost underwritten by government.

To some extent, these schemes may supplant commercial finance, as suggested by the fact that the Keystart arrangement accounts for more than 20 per cent of first home buyer loan approvals in WA (BCG Residential, sub. DR292, p. 3). But these arrangements also assist households that might otherwise be ineligible for finance or that, because of poor credit ratings, would only be able to obtain it at higher cost. The Housing Societies and Mortgage Managers Association commented:

> We can make loans to these people because we are involved at the 'coal face', interviewing all loan applicants, continuing to monitor and advise during the course of the loan, [with] strict collection procedures relating to any arrears collection. (sub. DR266, p. 4)

Schemes such as these have a role to play in helping low income households into home ownership. Indeed, they extend help to households that might otherwise be unable to purchase a home, even with the help of other arrangements such as the FHOS. However, they can involve greater inherent risk than a straightforward subsidy such as FHOS and, partly in consequence, their administrative costs are likely to be higher. Thus, the Commission would see such schemes as being of a 'specialist' nature, rather than vehicles for delivering widespread support to first home buyers.

Enhancing housing supply

As noted, several participants raised concerns about declines in the stock of housing affordable for first home buyers in general and low income households in particular. To remedy this perceived shortfall, a variety of supply-side schemes were proposed:

- *Government housing construction schemes* — the establishment of government-owned low-cost housing construction companies. The aim would be to augment private construction of low-cost dwellings suitable for first home buyers and other target groups. As well as constructing dwellings, these government companies would be responsible for selling the homes to target groups.

- *Public–private partnerships* — the provision of land or grants to private enterprise or community organisations to construct affordable housing that can be sold at low cost to first home buyers.
- *Subsidising private construction* — this would entail providing subsidies to developers to include a certain proportion of ‘affordable’ housing in each new development.
- *Requiring developers to fund or construct affordable housing* — this approach would require developers to contribute to an ‘affordable housing fund’ and/or to include an ‘affordable’ housing component in new housing developments.
- *Group self-build projects* — cooperative projects between the government, community organisations and future owners to construct houses for purchase by the households involved.

As set out above, notwithstanding its general preference for demand-side approaches, the Commission does see a potential role for supply-side schemes where very specific housing needs that are unlikely to be met by the private market are involved.

However, the proposals described above are much more general in nature. As such, they can provide a useful illustration of some of the deficiencies arising from the inherent prescriptiveness of supply-side approaches:

- All of these schemes would require the government to determine what type of dwellings would be most suited to the needs of recipients. With the best will in the world, catering for the diverse needs of even lower income home buyers would be very difficult.
- The first of these approaches would require government and thereby taxpayers to take on the risks of participation in the housing market. And where responsibility for the provision of the designated dwellings was passed onto the private sector, governments would still be obliged to undertake potentially costly tender and monitoring processes. Further, imposing affordable housing requirements on developers may have the inequitable and inefficient result of shifting some of the costs of meeting the housing needs of low income households from the community generally, initially to developers, and thereby to home buyers in the developments concerned and/or the owners of housing land.

Moreover, as under demand-side approaches, rules on which home buyers would be eligible to purchase dwellings constructed under these schemes would still be required. That is, supply-side schemes do not obviate the need for targeting and its associated costs. From this perspective, supply-side schemes simply involve an additional layer of bureaucracy.

Also, to the extent that the current stock of low cost housing is the outcome of normal demand and supply forces, increases in supply of such housing occasioned by the sort of schemes outlined above, may simply lead to offsetting reductions in private supply. Hence, the Commission reiterates that it sees the potential role for supply-side schemes to assist first home buyers as being limited to very specific situations.

Overcoming 'temporary' difficulty

The housing 'lifeline' proposal, developed by Gans and King (2003), was canvassed by the Home Ownership Taskforce. It involves establishing a loan facility which could be accessed by families in the event of short-term financial distress. Repayment of the loan would be linked to income, in a similar way to the Higher Education Contributions Scheme.

Gans and King (2003) suggested that the proposal could be implemented in a number of ways. Key design criteria would include whether to restrict eligibility through a means test, the level of the cap on total payments, and the rate of interest charged on loans.

The 'lifeline' proposal has the potential to increase home ownership in two ways:

- By funding mortgage repayments, it would help families in the event of short-term financial stress, reducing the likelihood of households being forced into default on their housing loans, with the consequent forced sale of their homes. Hence, the risks confronting those at the 'margin' of home ownership would be reduced.
- By providing a form of income 'insurance', it could make finance providers more willing to lend to higher risk borrowers.

The number of households that would potentially benefit from a housing lifeline scheme would depend crucially on scheme design — whether it was means tested, for example. However, there are several reasons why its effects on home *ownership* levels might be quite small:

- Because the scheme does not address the capacity of owners to service a mortgage over the borrowing period, it does not overcome the major obstacle to home ownership for many low income households. And, unlike the FHOS, it does nothing to overcome deposit gap problems.
- Families use a number of other strategies for guarding against periods of short-term financial stress — for example, income insurance, accumulating

savings that can be drawn down if needed, and building up credit through advance payments on their mortgages.

- Mechanisms are already available to help owners cope with short-term financial stress through, for example, varying repayment terms, refinancing the loan or obtaining bridging finance. Indeed, the Housing Industry Association considered that 'the market is already fairly well serviced as banks and other financial institutions can frequently accommodate these short-term changes' (sub. 177, p. 69). As well, some households may be eligible for assistance under state and territory mortgage assistance schemes. The NSW Government's Mortgage Assistance Scheme, for example, provides interest free loans to households facing difficulties in meeting mortgage repayments due to unexpected difficulties such as illness or loss of employment (sub. 187, p. 97). At the public hearings, ACOSS commented that it would agree with the conclusion that 'most state governments … broadly speaking … meet the same need, so an additional federal measure is probably not warranted' (trans., p. 115).

Thus, in the Commission's view, the case for government funding for a new lifeline-type scheme is very weak.

Financing assistance for home ownership

As discussed earlier, participants put forward for consideration a number of possible bond and equity schemes designed to raise finance for the provision of low cost rental accommodation. These schemes, which would involve government subsidy, could equally be used separately or in tandem to finance support for first home buyers, delivered in whatever form governments judged to be most appropriate.

In this inquiry, the Commission has not sought to evaluate the relative merits of these different financing approaches. Rather, its focus has been on what *form* of assistance to promote home ownership is likely to provide the greatest benefit to the community, and whether larger benefits might arise were those funds spent in other ways. The Commission notes that the Allen Consulting Group Report (see box 10.3) was ambivalent about which of these financing instruments would be most beneficial.

However, the Commission considers that these instruments, and their potential application to financing affordable rental housing initiatives as well as to assisting first home buyers, could usefully be subject to further assessment as part of the proposed public inquiry into the housing needs of low income households.

APPENDIXES

A Public consultation

A.1 Submissions

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Australian Democrats	205
Australian Federation of Homelessness Organisations	136
Australian Housing and Urban Research Institute	141
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Zhong, Jianying	64, 223#, DR263#

Note. An asterisk (*) indicates that the submission contains confidential material not available to the public. A hash (#) indicates that the submission includes attachments.

A.2 Visits

New South Wales

Australian Bankers' Association
BIS Shrapnel
CPG Developments
Housing Industry Association (members roundtable)
Meriton
NSW Government Departments
Penrith City Council
Property Council of Australia (members roundtable)
Reserve Bank of Australia
Sydney Water Corporation

Victoria

Australian Bankers' Association
Australian Bureau of Statistics
Australian Housing and Urban Research Institute
AV Jennings Limited
City West Water
Department of Sustainability and Environment
Department of the Treasury and Finance
Henley Properties
Housing Industry Association
La Trobe University
MacroPlan Pty Ltd
Master Builders Association of Victoria
Melbourne Business School
Melbourne Institute of Applied Economic and Social Research
Melbourne Water
Murdoch University
Urban Development Institute of Australia (Victoria)
Vic Roads
VicUrban
Wyndham City Council
Yarra Valley Water

Queensland

Property Council of Australia
Queensland Government Departments (roundtable)
Treasury

Western Australia

Department of Treasury and Finance
Government Departments (roundtable)

South Australia

Department of Treasury and Finance
Government Departments (roundtable)

ACT

Building Products Innovation Council
Department of Family and Community Services
Department of Prime Minister and Cabinet
Department of the Treasury (Australian)
Department of Transport and Regional Services
Housing Industry Association Ltd
Master Builders Australia Inc

Northern Territory

Treasury and Government Departments (roundtable)

A.3 Productivity Commission roundtable (Sept. 2003)

Australian Bankers' Association
Australian Housing and Urban Research Institute
Australian Local Government Association
AV Jennings Limited
Bird, Neil
Brotherhood of St Laurence
Department of Disability, Housing and Community Services (ACT)
Department of Human Services
Department of Sustainability and Environment
Department of the Treasury (Australian)
Department of Treasury and Finance (SA)
Department of Treasury and Finance (Tasmania)
Department of Treasury and Finance (Victoria)
Department of Treasury and Finance (WA)
Freebairn, John (University of Melbourne)
Gans, Joshua (Melbourne Business School)
Henley Properties Group
Housing Industry Association
Master Builders Australia Inc
McDonald, Peter (Australian National University)
Mortgage Industry Association of Australia
Northern Territory Treasury
NSW Government
Planning Institute of Australia
Queensland Treasury
Real Estate Institute of Australia
Reserve Bank of Australia
Yates, Judith (Sydney University)

A.4 Public hearings

Date	*Participant*
Brisbane	in Tempore Advisory
28 January 2004	Kopfsovitz, Vis
	Local Government Association of Queensland
	May, Richard
	Prosper Australia
	Queensland Shelter
	Rowan, Peter
	Yarrum Equities Pty Ltd
Sydney	Australian Council of Social Service
2 February 2004	Housing Industry Association
	Local Government Association of NSW and Shires Association of NSW
	Master Builders Australia Inc
	Property Council of Australia
Sydney	Association for Good Government
3 February 2004	Construction, Forestry, Mining and Energy Union
	Council of Social Service of NSW and Shelter NSW
	Hall, Alan
	Land Tax Targets Tenants
	Pollard, Paul
Melbourne	Australian Association of Social Workers
9 February 2004	Australian Council of Trade Unions
	Australian Currency Taskforce
	Darebin City Council
	Hay, Andrew
	Housing Justice Roundtable
	Langford-Jones Homes
	Urban Development Institute of Australia (Victoria)
	Urban Land & Housing Group
	Wyndham City Council
Melbourne	Breward, Alun
10 February 2004	Brotherhood of St Laurence
	Cooke, Stan
	Housing Societies and Mortgage Managers Association
	Melbourne Law School
	Municipal Association of Victoria
	Planning Institute of Australia
	Real Estate Institute of Australia

B Who are the first home buyers?

In this appendix, a profile of the demographic and economic circumstances of first home buyers is presented, to shed light on the influence of rising housing prices on the demand for first homes and to assist with the consideration of housing assistance measures. The buyer characteristics examined are:

- age;
- household composition;
- income and employment;
- housing costs;
- value of home purchased;
- location; and
- dwelling characteristics.

The information sources for first home buyer household characteristics were various housing surveys (principally the ABS Survey of Income and Housing Costs) conducted over the years from 1990 to 2000-01. However, survey data are not yet available for first home buyers in the last couple of years when house prices have risen by up to 40 per cent in some cities. The main information source for first home prices and locations was data collected from the recipients of First Home Owner Scheme (FHOS) grants over the period 2000-01 to 2002-03.

B.1 Age

Between 1990 and 2000-01, the majority of first home buyers were in their late twenties or early thirties (see table B.1). Only a small proportion bought their first home when aged over 45.

Table B.1 **Age distribution of first home buyers**

Age of household reference person[a]	*1990*	*1994*	*1995-96*	*1997-98*	*2000-01*
	Per cent of recent first home buyers[b]				
15 to 24	14.9	15.5	12.4	11.0	9.9
25 to 34	54.3	55.6	56.2	56.1	60.6
35 to 44	19.8	21.0	21.9	22.0	18.9
45 to 54	7.6	4.3	4.4	6.4	7.6
55 and over	3.2	3.5	5.2	4.5	3.0
Average age (years)	**32.7**	**32.0**	**32.9**	**33.2**	**33.0**

[a] Typically, one of the partners in a couple household, the parent in a single-parent household or the person in a lone-person household. [b] Households that purchased their first home in the three years preceding the survey.

Sources: ABS (*1988 to 1990 First Home Buyers, Australia*, Cat. no. 4137.0; *Housing Occupancy and Costs*, Cat. no. 4130.0); unpublished data from ABS 2000-01 Survey of Income and Housing Costs.

Over the decade to 2000-01, the age distribution of first home buyers has been relatively stable (see table B.1). The average age at first home purchase, of around 33, has remained virtually unchanged, as has been the proportion of first home buyers aged at 34 or under (70 per cent). However, some small compositional changes have occurred within various age groups.

B.2 Household composition

Between 1990 and 2000-01, couples were the most common household type purchasing a first home (see table B.2). Of this group, approximately half had no children when they purchased. The proportion of couples with dependent children (that is, nuclear families) has declined slightly since the mid-1990s.

Table B.2 **Household composition of first home buyers**

Selected household type	*1990*	*1994*	*1995-96*	*1997-98*	*2000-01*
	Per cent of recent first home buyers[a]				
Couple only	32.5	34.0	29.8	33.8	32.3
Couple with children	36.4	34.2	32.8	31.2	32.9
with dependent children only	na	na	29.6	29.3	27.1
Single parent	4.8	3.3	3.3	4.4	4.2
Lone person	12.1	15.7	23.2	17.3	17.5
aged under 35	na	na	na	na	11.9

[a] Households that purchased their first home in the three years preceding the survey. **na** Not available.

Sources: ABS (*1988 to 1990 First Home Buyers, Australia*, Cat. no. 4137.0; *Housing Occupancy and Costs*, Cat. no. 4130.0); unpublished data from ABS 2000-01 Survey of Income and Housing Costs.

While single-parent households account for a small proportion of first home buyers, lone-person households have become a more significant purchasing group.

B.3 Income and employment

First home buyers tend to have higher incomes than other households. In 2000-01, for example, recent first home buyers had an average weekly household income of $1200 before tax — 21 per cent more than the average income of all households. Over 50 per cent of them were in the top two income quintiles (see table B.3).

Table B.3 **Income distribution of first home buyer households**

Income quintile	*1994*	*1995-96*	*1997-98*	*2000-01*
	Per cent of recent first home buyers[a]			
Lowest	4.9	8.7	8.4	5.8
Second	14.4	11.6	13.2	12.2
Third	25.7	26.9	24.2	27.2
Fourth	31.9	35.1	31.7	29.7
Highest	23.1	17.7	22.5	25.1

[a] Households that purchased their first home in the three years preceding the survey.

Sources: ABS (*Housing Occupancy and Costs*, Cat. no. 4130.0); unpublished data from ABS 2000-01 Survey of Income and Housing Costs.

Moreover, the average household incomes of first home buyers have been rising faster (45 per cent) than average household income overall (37 per cent). The share of first home buyers in the lowest two household income quintiles fell slightly between 1994 and 2000-01.

Excluding those not in the workforce, such as retirees and students, all but 3 per cent of households that purchased their first home in the three years to 2000-01 were in full or part-time employment. As well as having higher employment than the general workforce, the majority of first home buyer households had at least two income earners and the proportion has grown since the mid-1990s — helping to explain the more rapid rise in weekly income of recent first home buyers than of households generally (see table B.4). The growing proportion of first home buyer households with at least two incomes, may in turn partly be in response to rising house prices.

Table B.4 **Employment status of first home buyers**

Number of earners	*1995-96*	*1997-98*	*2000-01*
	Per cent of recent first home buyers[a]		
Two or more	49.2	54.1	54.0
at least two full-time workers	na	na	40.4
at least one full-time worker and at least one part-time worker	na	na	14.2
One	42.1	34.9	38.8
None	8.7	11.0	7.2
at least one person seeking work	na	na	2.9
no person in the workforce	na	na	4.3

[a] Households that purchased their first home in the three years preceding the survey. **na** Not available.

Sources: ABS (*Housing Occupancy and Costs*, Cat. no. 4130.0); unpublished data from ABS 2000-01 Survey of Income and Housing Costs.

B.4 Housing costs

In 2000-01, about 87 per cent of first home buyer households that purchased their first home in the three preceding years had a mortgage (compared with 89 per cent in 1990). On average, they spent $264 a week on mortgage repayments and property rates. For recent first home buyer households without a mortgage, the other housing costs averaged $54 a week.

Over the decade to 2000-01, weekly housing costs of first home buyer households rose by 13 per cent on average. This was unlikely to have been affected by a change in the relative numbers of buyers with and without mortgages, which remained generally stable over the period. Rather, the impact on housing costs of lower interest rates was more than offset by a rise in average loans.

However, because of their strong income growth, housing costs for first home buyer households, generally fell as a proportion of household income. First home buyer households commonly spent less than 30 per cent of their income on housing costs in 2000-01 (see table B.5). Housing costs as a proportion of income were considerably higher for households in the lowest income quintile. However, the income estimates for these households could potentially be unreliable because of a limited sample size and underreporting of income. The decline in housing costs as a proportion of income was most notable for first home buyers in the second income quintile.

Table B.5 **Housing costs of first home buyers**

Income quintile	*1990*	*1995-96*	*1997-98*	*2000-01*
	Per cent of pre-tax household income [a]			
Lowest	na	42	58	(**b**)
Second	na	36	27	28
Third	na	26	26	26
Fourth	na	21	22	20
Highest	na	19	15	16
All income classes	**26**	**23**	**21**	**20**

[a] Ratio of average weekly housing costs (including mortgage payments and property rates) to the average weekly income for recent first home buyers in the same income quintile. Households with nil or negative income are excluded in this calculation. [b] Estimate not included because it is potentially unreliable (see text). **na** Not available.

Sources: ABS (*Housing Occupancy and Costs*, Cat. no. 4130.0); unpublished data from ABS 2000-01 Survey of Income and Housing Costs.

B.5 Value of home purchased

Not surprisingly, first home buyers generally purchase cheaper homes than change-over buyers. In the second half of the 1990s, the average value of first owned homes was just under 80 per cent of the average value of homes bought by change-over buyers (see table B.6).

Table B.6 **Median values of first owned homes**

Income quintile	*1995-96*		*1997-98*		*2000-01*	
			($'000)			
Lowest	108	(90)	107	(94)	(**a**)	
Second	116	(92)	105	(88)	120	(72)
Third	105	(74)	121	(81)	140	(78)
Fourth	123	(76)	126	(75)	160	(76)
Highest	140	(61)	144	(62)	200	(67)
All income classes	**121**	**(74)**	**124**	**(77)**	**155**	**(78)**

Note. The nominal home value is estimated and reported by the household respondent, so it may differ from the purchase price. Figures in parentheses are the ratios (in per cent) of the median value of homes bought by recent first home buyers to the median value of homes bought by recent change-over buyers in the same household income quintile. [a] Estimate not included because it is potentially unreliable. **na** Not available.

Sources: ABS (*Housing Occupancy and Costs*, Cat. no. 4130.0); unpublished data from ABS 2000-01 Survey of Income and Housing Costs.

In 2000-01, purchase prices ranged between a national average of $120 000 for lower income first home buyers and $200 000 for those at the upper end of the income distribution. The variation in first home purchase prices across household income quintiles

was previously smaller, roughly between $100 000 and $150 000 in both 1995-96 and 1997-98.

The relative price difference between first home and change-over purchases also varies across income quintiles (see table B.6). It was less for households in the lowest income quintile but over 30 per cent lower for those in the highest income quintile.

Prices paid for first owned homes in metropolitan and regional areas

Consistent with the national picture, median prices paid by first home buyers in larger capital cities were lower than city-wide medians (see table B.7). For example, the median prices paid by the recipients of the FHOS grants between 2000-01 and 2002-03 in Melbourne, Brisbane and Adelaide were about 10 to 20 per cent below the city-wide median prices. In Sydney, the median first home price was nearly 30 per cent below the market median. The wider price gap supports the widely held perception that first home buyers in Sydney face greater price constraints in choosing an affordable home than first home buyers in the other capital cities.

Table B.7 **Home prices paid by FHOS grant recipients in selected capital cities**

City	*Period*	*Median price of first owned homes*[a]	
		$'000	As a percentage of city-wide median price
Sydney	2000-01	218	74
	2001-02	250	71
	2002-03	305	72
Melbourne[b]	2000-01 to 2002-03	182	80
Brisbane	2000-01	137	77
	2001-02	151	88
	2002-03	185	86
Adelaide	2000-01	120	84
	2001-02	135	82
	2002-03	160	79

[a] For Sydney and Melbourne, the median first home price is estimated using detached-house price data. For Brisbane and Adelaide, price data for all dwelling types were used. [b] For Melbourne, the median price is estimated for the three-year period as FHOS price data for individual financial years were unavailable to the Commission.

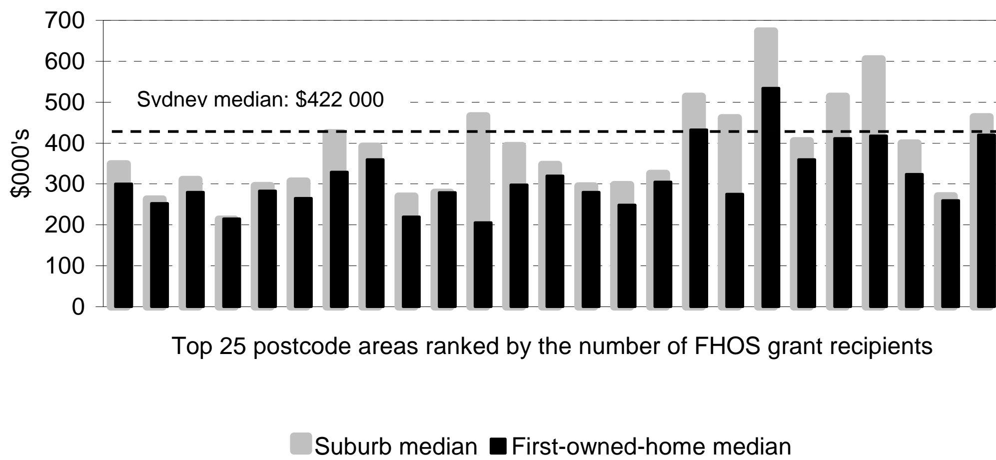
Sources: Productivity Commission estimates based on unpublished FHOS data from NSW Office of State Revenue, Victorian Department of Treasury and Finance, Queensland Department of Treasury and SA Department of Treasury and Finance.

The gap between the average prices paid by first home buyers and other buyers (including investors and change-over buyers) appears to be mainly attributable to them buying properties in cheaper suburbs rather than buying cheaper dwellings across cities. In Sydney

and Melbourne, the median price paid by first home buyers was generally close to the suburb median price. However, median prices in the suburbs where most of the first home purchases were made were often more than 20 per cent below the city-wide median (see figures B.1 and B.2).

Housing in many regional areas appears to be more affordable for first home buyers than in metropolitan areas. For example, first home buyers in many regional centres in NSW and Victoria have typically bought homes with values close to market averages (see table B.8).

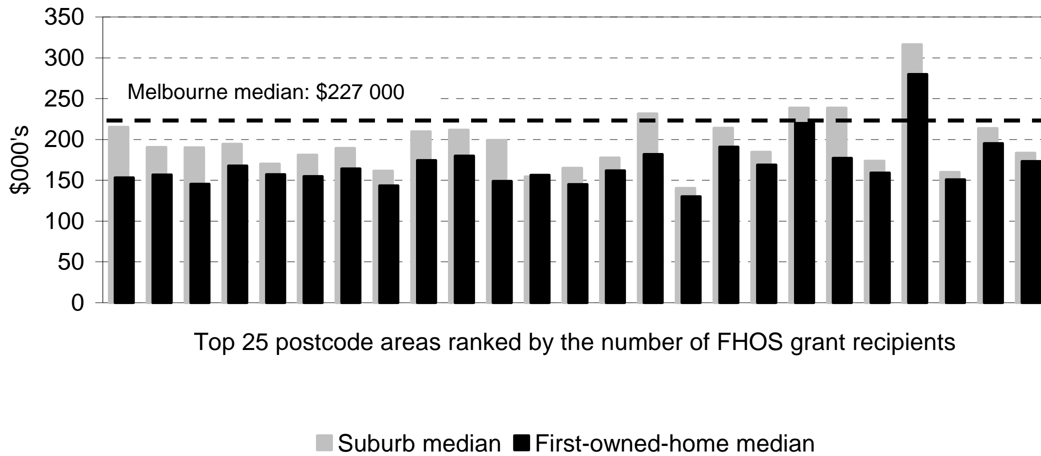
Figure B.1 **House prices by postcode in Sydney, 2002-03**



Note. The postcode areas included accounted for 41 per cent of FHOS grant recipients in Sydney.

Data sources: Unpublished FHOS data from the NSW Office of State Revenue; unpublished suburb price data from the NSW Housing Department.

Figure B.2 **House prices by postcode in Melbourne, 2000-01 to 2002-03**



Note. The postcode areas included accounted for 36 per cent of FHOS grant recipients in Melbourne. The median prices are estimated for the three-year period as FHOS price data for individual financial years were unavailable to the Commission.

Data sources: Unpublished FHOS data from the Victorian Department of Treasury and Finance; suburb price data from the Department of Sustainability and the Environment (2003a).

Table B.8 **Home prices paid by FHOS grant recipients in selected regional localities**

Locality[a]	*Median price of first owned homes*	
	$'000	As a percentage of market-wide median price
New South Wales (2002-03)		
Newcastle	130	81
Wollongong	160	85
Albury	110	95
Wagga Wagga	116	85
Victoria (2000-01 to 2002-03)[b]		
Geelong	147	86
Ballarat	123	90
Mildura	128	87
Bendigo	117	86
Wodonga	124	86

[a] The NSW localities included in the analysis accounted for 39 per cent of the number of FHOS grants for home purchases outside Sydney in 2002-03. The corresponding coverage of FHOS grant recipients in country Victoria was 34 per cent. [b] The median prices for Victorian localities are estimated for the three-year period as FHOS price data for individual financial years were unavailable to the Commission.

Sources: Productivity Commission estimates based on unpublished FHOS data from NSW Office of State Revenue and Victorian Department of Treasury and Finance, and locality price data from NSW Department of Housing (*Rent and Sales Report*, various issues) and DSE (2003a).

B.6 Location

The geographic distribution of first home buyers broadly accords with the distribution of population across states and territories (see table B.9). About 70 per cent of recent first home buyers live in capital cities, compared with 60 per cent of all resident households.

Table B.9 **Distribution of first home purchases by state and territory**

	1990[a]	*1999*[a]	*2000-01*[a, b]	*2002-03*[c]
	Per cent of recent first home buyers[d]			
New South Wales	32	33	27 (21)	30
Victoria	25	29	29 (21)	23
Queensland	16	15	19 (10)	22
Western Australia	11	8	12 (9)	11
South Australia	10	9	6 (5)	8
Tasmania	4	3	3 (1)	3
Northern Territory	1	1	3 (na)	1
Australian Capital Territory	2	2		2

[a] Based on ABS survey data. [b] Figures in parentheses are for capital cities. [c] Based on FHOS data covering 2000-01 to 2002-03. [d] Households that purchased their first home in the three years preceding the survey and data collection. **na** Not available.

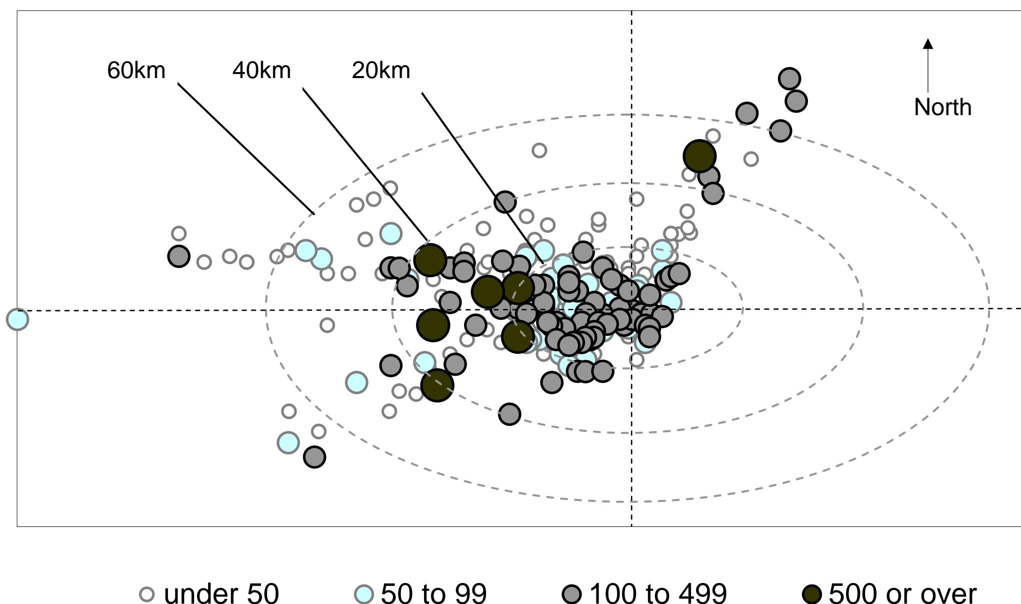
Sources: ABS (*1988 to 1990 First Home Buyers, Australia*, Cat. no. 4137.0; *Australian Housing Survey*, Cat. no. 4182.0); unpublished data from ABS 2000-01 Survey of Income and Housing Costs; unpublished FHOS data from Australian Government Treasury.

Intra-city location choices

According to data obtained from the recipients of FHOS grants in Sydney, Melbourne and Adelaide, the location choices of first home buyers in these cities vary considerably.

In Sydney, recent first home buyers have located mainly in suburbs with cheaper prices such as the city's outer western areas (see figure B.3). In the three years to 2002-03, Sydney's middle and outer suburbs were the choice of 32 per cent and 35 per cent of first home buyers respectively (see figure B.4). Another 15 per cent purchased at the urban fringe. And, while less than 20 per cent purchased in Sydney's inner areas, this share is higher than in the past, with increasing numbers of first home buyers purchasing inner-city apartments and other high-density dwellings.

Figure B.3 **Geographic distribution of first home purchases in Sydney, 2000-01 to 2002-03**



○ under 50 ○ 50 to 99 ● 100 to 499 ● 500 or over

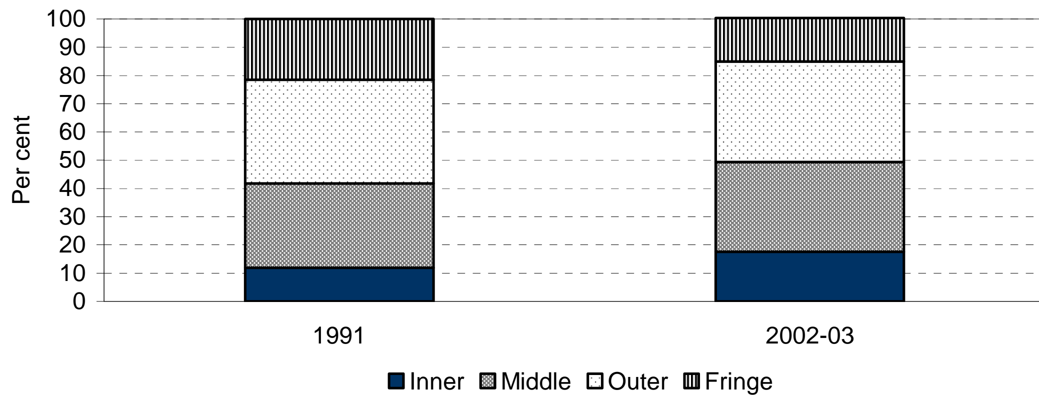
Note. Data points refer to postcode areas and are grouped by the average annual number of first home purchases over the period 2000-01 to 2002-03. Concentric ovals indicate the distance from the central business district.

Data source: Productivity Commission estimates based on unpublished FHOS data from NSW Office of State Revenue.

In Melbourne, many recent first home buyers have purchased in the city's south–eastern, northern and north–western suburbs (see figure B.5). Of all recent first home purchases in the city, 15 per cent were in fringe areas, 34 per cent in outer areas, 36 per cent in middle areas and 14 per cent in inner areas. In contrast to Sydney, the number of first home buyers purchasing a home in Melbourne's fringe areas has increased over the past decade (see figure B.6).

In Adelaide, there seems to be no distinct geographic concentration of recent first home purchases (see figure B.7), though over 70 per cent have been within 20 kilometres of the city centre.

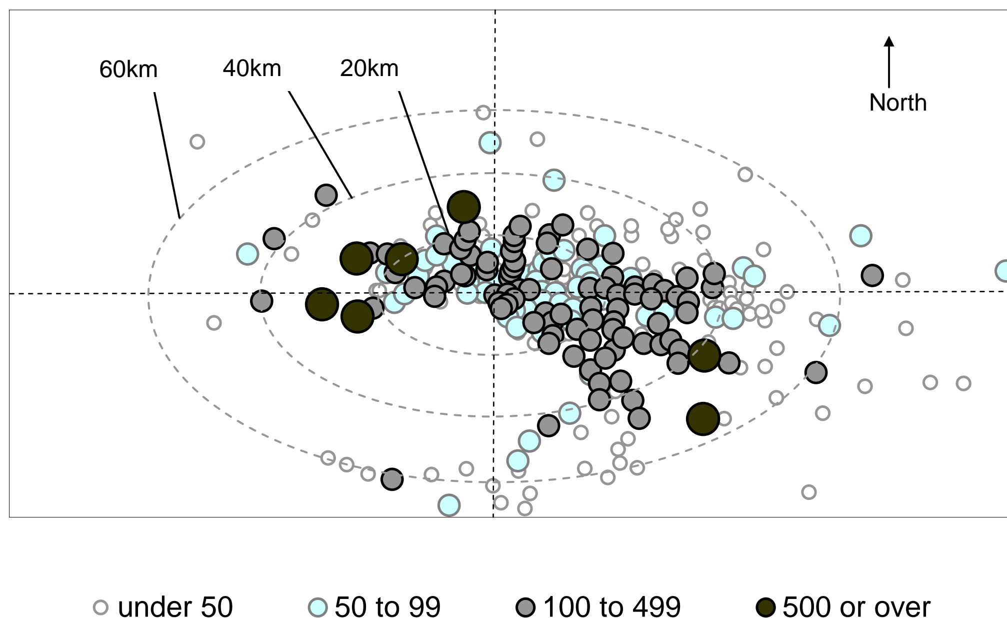
Figure B.4 **Change in the geographic distribution of first home purchases in Sydney**



Note. The zones in Sydney are defined as follows: (i) inner zone — less than 10 kilometres from the CBD; (ii) middle zone — between 10 kilometres and 30 kilometres from the CBD; (iii) outer zone — between 30 kilometres and 50 kilometres from the CBD; and (iv) fringe zone — more than 50 kilometres from the CBD. The distribution is based on the number of first home purchases in the three years preceding the survey.

Data sources: Productivity Commission estimates based on unpublished FHOS data from NSW Office of State Revenue and unpublished data from the 1991 Housing and Location Choice Survey commissioned by the National Housing Strategy Advisory Committee (NHS 1992).

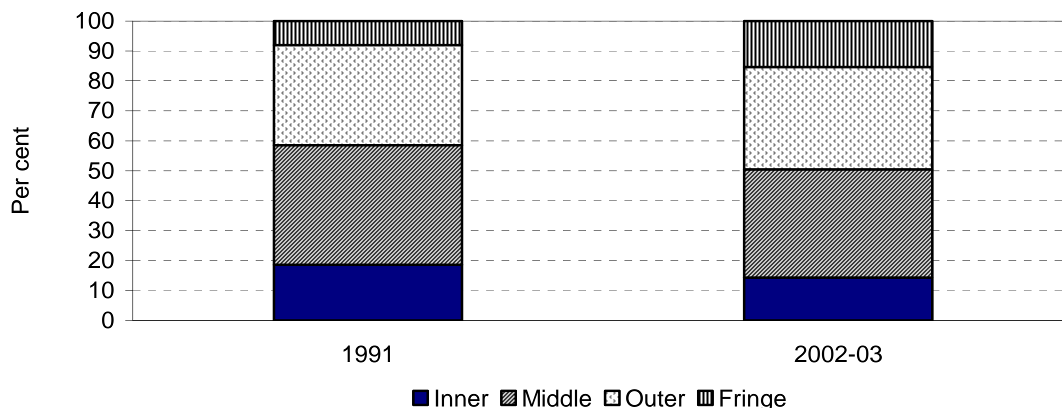
Figure B.5 **Geographic distribution of first home purchases in Melbourne, 2000-01 to 2002-03**



Note. Data points refer to postcode areas and are grouped by the average annual number of first home purchases over the period 2000-01 to 2002-03. Concentric ovals indicate the distance from the CBD.

Data source: Productivity Commission estimates based on unpublished FHOS data from the Victorian Department of Treasury and Finance.

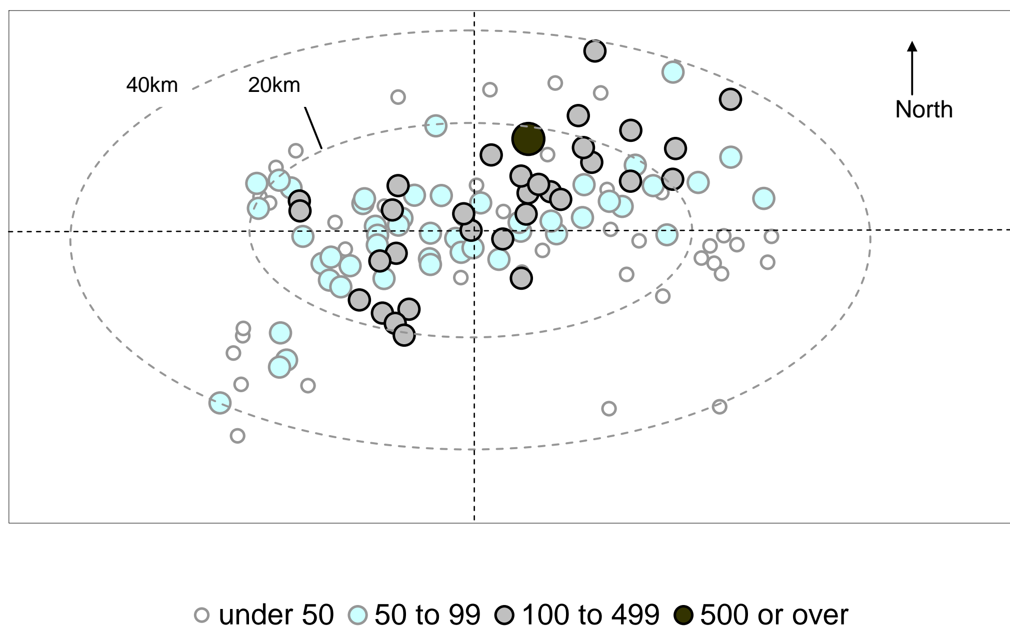
Figure B.6 **Change in the geographic distribution of first home purchases in Melbourne**



Note. The zones in Melbourne are defined as follows: (i) inner zone — less than 10 kilometres from the CBD; (ii) middle zone — between 10 kilometres and 25 kilometres from the CBD; (iii) outer zone — between 25 kilometres and 40 kilometres from the CBD; and (iv) fringe zone — more than 40 kilometres from the CBD. The distribution is based on the numbers of first home purchases in the three years preceding the survey.

Data sources: Productivity Commission estimates based on unpublished FHOS data from the Victorian Department of Treasury and Finance and unpublished data from the 1991 Housing and Location Choice Survey commissioned by the National Housing Strategy Advisory Committee (see NHS 1992).

Figure B.7 **Geographic distribution of first home purchases in Adelaide, 2000-01 to 2002-03**



Note. Data points refer to postcode areas and are grouped by the average annual number of first home purchases over the period 2000-01 to 2002-03. Concentric ovals indicate the distance from the CBD.

Data source: Productivity Commission estimates based on unpublished FHOS data from SA Department of Treasury and Finance.

B.7 Dwelling characteristics

Detached houses are the most common type of first owned homes in Australia, accounting for just under 80 per cent of dwellings occupied by recent first home buyers in 2000-01 (see table B.10). This compares with 84 percent for change-over buyers. However, higher-density living has increased among first home buyers, with the proportion of townhouse and apartment purchases rising from 12 per cent to 20 per cent over the decade to 2000-01.

Table B.10 **Selected dwelling characteristics**

	1990	*1994*	*1995-96*	*1997-98*	*2000-01*
	Per cent of recent first home buyers[a]				
Dwelling structure					
separate house	87	82	82	82	79
semi-detached townhouse	5	9	8	7	9
apartment or flat	7	9	8	10	11
Dwelling age					
new	na	26	23	18	20
established	na	74	77	82	80
	Average number of bedrooms				
Dwelling size	2.8	2.9	2.8	2.9	3.0

[a] Households that purchased their first home in the three years preceding the survey. **na** Not available.

Sources: ABS (*Housing Occupancy and Costs*, Cat. no. 4130.0); unpublished data from ABS 2000-01 Survey of Income and Housing Costs.

A large and increasing majority of first home buyers purchase established dwellings, with the proportion rising from 74 per cent in 1994 to 80 per cent in 2000-01. The pattern was similar for change-over buyers, with the proportion who purchased established dwellings increasing from 67 to 78 per cent over the same period.

Over the decade to 2000-01, first home buyers also tended to purchase bigger homes — for example, the average number of bedrooms in a first owned home increased from 2.8 in 1990 to 3.0 in 2000-01. For change-over buyers, the average number of bedrooms in the purchased home also increased — from 3.1 to 3.3 over the same period.

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