Australia's housing crisis

Submission to the People's Commission into the Australian Housing Crisis

by

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Introduction

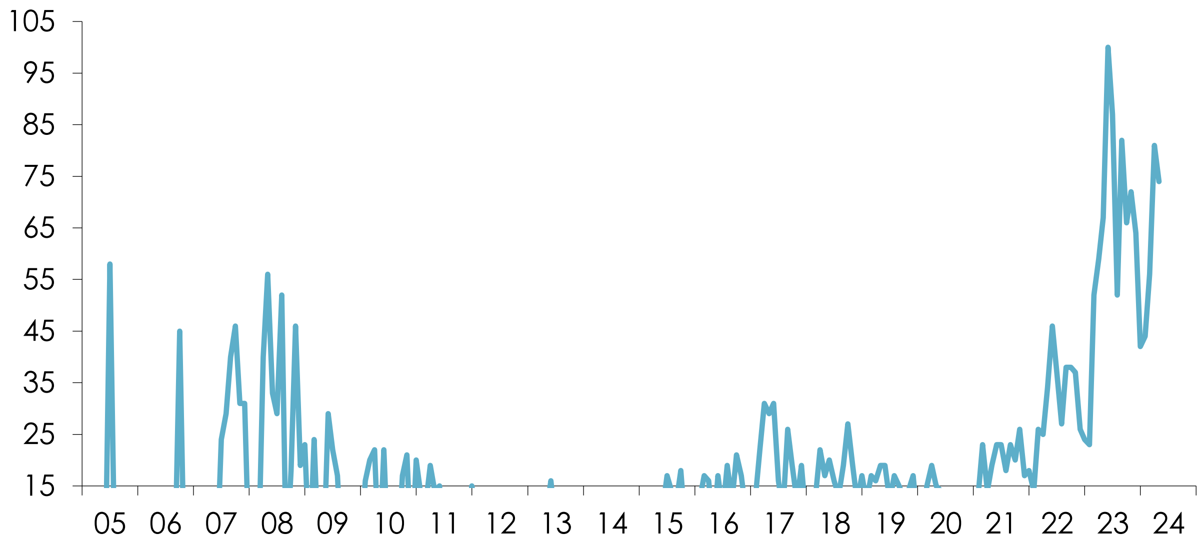
Australian housing markets and government housing policies are issue about which I've written and spoken at considerable length for more than forty years. Rather than recapitulate that, I've provided at Attachments 1 and 2, respectively, to this submission, copies of an essay published by the *Pearls and Irritations* blog in May 2017, and a submission I made to the Senate Economics References Committee's Inquiry into Affordable Housing in December 2013.

What follows hereafter (before the two Attachments) is an update of some of the data set out and views expressed in those two pieces of work.

Australia's 'housing crisis'

There's a growing sense that Australia is in the midst of a 'housing crisis'. One indication of that is the increase in online searches for that phrase, as shown in Chart 1.

Chart 1: Online searches for 'housing crisis'



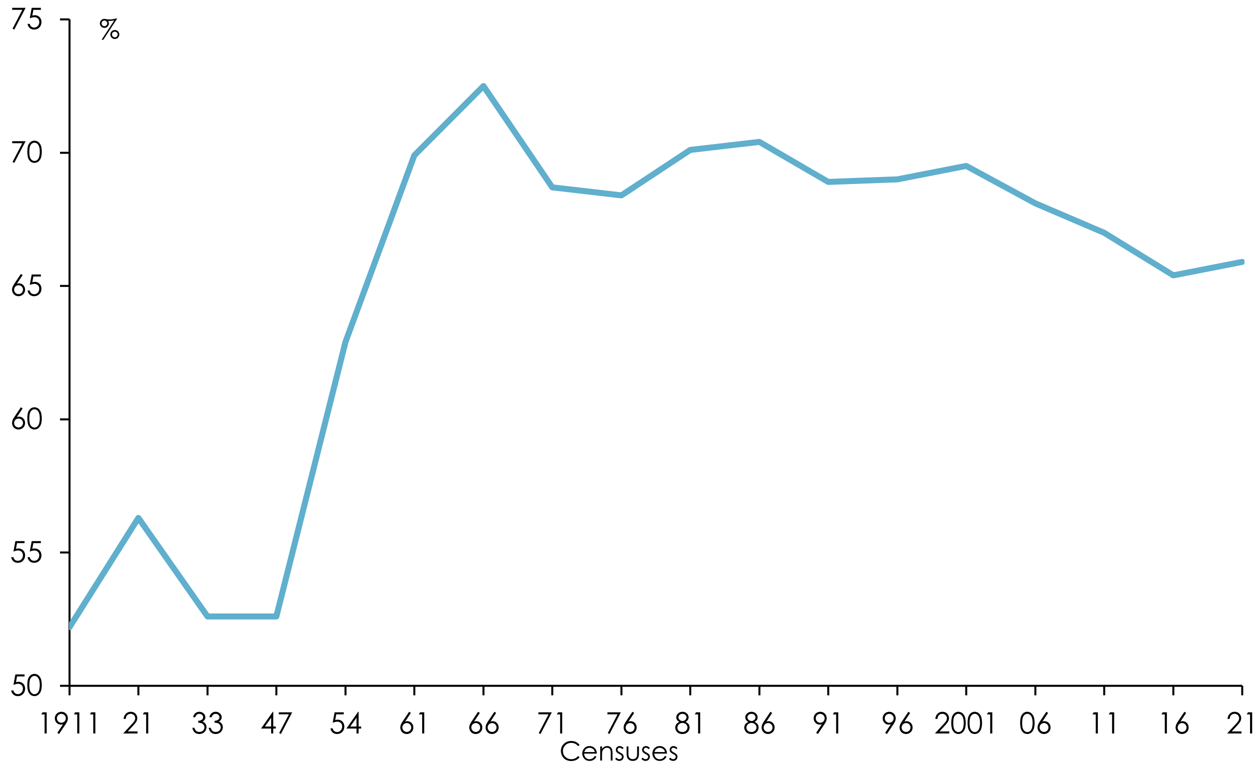
Note: Numbers represent search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. A score of 0 means there was not enough data for this term. *Source:* Google Trends.

The Australian 'housing crisis' has a number of dimensions. In particular, housing costs have been a major contributor to the rise in inflation since the end of the Covid-19 pandemic, with rents rising by 11.5% and new dwelling purchase costs by 23.8% over the two years to the December quarter of 2023, as against a 7.7% increase in wages (ABS 2024a, ABS 2024b). Almost 122,500 people were estimated to be experiencing homelessness at the time of the last Census, in August 2021 a 50% increase from the number at the time of the 2001 Census (ABS 2023). The proportion of low-income rental households (those in the bottom 40% of the income distribution) spending more than 30% of their income on housing rose from 21.6% in 2009-10 to 46.7% in 2019-20, while the proportion of low-income owner-occupier households with a mortgage spending more than 40% of their income on housing rose from 21.6% to 37.4% over the same period (ABS 2022b), and both proportions will almost certainly have risen further since then.

Just as it has multiple dimensions, the Australian 'housing crisis' has multiple causes. One of those causes is the long-term decline in rates of home ownership, not least because it has contributed to the ongoing increase in the demand for rental accommodation. People who, in previous generations, would have owned their own homes, are instead renting – either for longer periods before becoming home-owners, or without ever becoming home-owners – and increasingly competing with people who, both in previous generations and at present, would never have been able to attain home ownership, for the limited supply of rental accommodation.

Australia's home ownership rate, as recorded in successive Censuses, peaked at 72.5% in 1966, and thereafter declined to 65.4% in 2016 before ticking up slightly to 65.9% in 2021 (Chart 2).

Chart 2: Australia's home ownership rate at Censuses



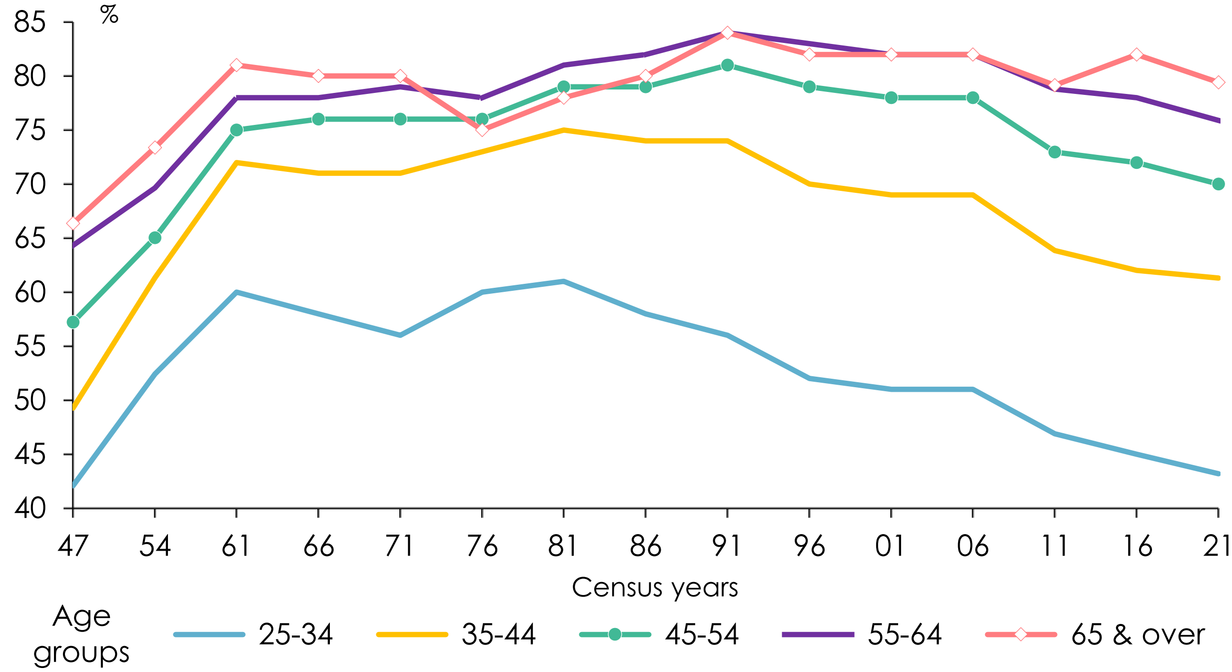
Sources: ABS (1996, 2009 and 2022c); Advisory Council on Inter-Government Relations (1981).

The apparently relatively small decline in Australia's overall home ownership rate over the past six decades conceals much larger declines in home ownership rates among every age group except those aged 65 and over.

This is illustrated in Chart 3, which shows that the home ownership rate among people aged 25-34 has declined by 17 percentage points from its peak in 1961, to be only 1 percentage point above where it was at the Census of 1947. The home ownership rate among people aged 35-44 has fallen by 14 percentage points from its peak in 1981, to be back to where it was at the Census of 1954. The home ownership rate among people aged 45-54 has fallen by 11 percentage points from its peak in 1991, to below where it had been at the Census of 1961. And the home ownership rate among people aged 55-64 has fallen by 8 percentage points from its peak, also in 1991, to below where it had been sixty years earlier.

The only age group among whom the home ownership rate has fallen by less than the overall rate is those aged 65 and over, for whom it has dropped by only 5 percentage points. But this group's share of the total Australian population increased by 8.5 percentage points between the 1966 and 2021 Censuses.

Chart 3: Australia's home ownership rate at Censuses, by age group



Sources: Yates (2015); Daley and Coates (2018); Clun (2022).

There is no single cause of the decline in home ownership rates, especially among younger age cohorts, over the past six decades.

One sometimes over-looked factor is the profound changes that have taken place in the life trajectories of young adults since the years immediately after the end of World War II, and especially since the early 1970s. Between 1940 and 1974 the median age at first marriage (often a stage in life associated with the purchase of a first home) declined from 26.5 to 23.3 years for men, and from 23.3 to 20.9 years for women; but since 1974 it has risen to 32.5 for men and 30.9 for women (Qu and Baxter 2023). There has likewise been a significant increase in the age at which women have their first child (also traditionally a key 'trigger' for the decision to purchase a home). These trends are by no means unique to Australia, but have occurred in almost all 'advanced' economies (OECD 2024).

Young people stay in the education system for much longer than was customary in the 1950s and 1960s, and if they undertake tertiary education, emerge from it with significant HELP (formerly HECS) debt (averaging $26,495 in 2022-23, up from $10.459 in 2005-06), which was not a consideration for people who entered tertiary education before 1989 (the number of outstanding HELP/HECS debtors as a proportion of the population aged 22-45 has risen from 17.5% to 34% between 2005-06 and 2022-23) (ATO 2023).

However, it is clearly the case that the decline in home ownership rates over the last thirty years in particular also owes much to declining housing affordability (Eslake 2013 and 2017b; Reserve Bank of Australia 2021: 4-9; Kohler 2023).

'Housing affordability' is an inexact concept, open to measurement in a variety of ways, and with different implications depending on how it is measured. One indication is given in Chart 4, which shows quarterly median dwelling prices as a multiple of annual average household disposable income per person of working age (ie, 15 and over).

Chart 4: Median Australian dwelling prices as a multiple of annual household disposable income per person of working age

Sources: CoreLogic (2024), ABS (2024c and 2024d); Corinna Economic Advisory calculations.

Over the period depicted in Chart 4, median dwelling prices rose by 1,991% (equivalent to an average annual rate of 7.3%); while household disposable income per person aged 15 and over rose by 632% (equivalent to an average annual rate of 4.7%). For reference, the consumer price index rose by 400% over the same period (equivalent to an average annual rate of 3.8%; while the national accounts measure of average employee earnings rose by 554% (equivalent to an average annual rate of 4.5%).

The ratio of dwelling prices to this measure of household income rose from 4.5 times to 12.3 times over the 43-year period shown in Chart 4. Of this increase, just over three-quarters occurred in two distinct periods, between the December quarters of 1998 and 2007 (when it rose from 6.1 to 10.0), and between the December quarters of 2011 and 2017 (when it rose from 8.9 to 11.4). A further significant increase occurred between the September quarter of 2020 and the December quarter of 2021, when the ratio rose from 10.1 (having fallen over the preceding three years) to 12.6.

The significant increase in the ratio of dwelling prices to household disposable incomes over this period had two important (and highly detrimental) consequences for aspiring home-buyers.

First, it has meant that would-be first-time buyers need to accumulate much larger deposits in order to qualify for a mortgage given the usual requirement for a deposit of 20% of the purchase price (without being required to take out lenders' mortgage insurance). One calculation suggests that an average-income household would need to save 20% of its income for 5.7 years in order to accumulate a 20% deposit on a median-priced home in 2023, compared with 4.7 years in 2013 and 3.9 years in 2003 (Jopson 2023).

Second, it has required first-time buyers to take out and service much bigger mortgages, relative to their incomes, than has been required of previous generations of first-time buyers. The average mortgage taken out by a first-home buyer rose from $74,580 in the December quarter of 1991 to $656,000 in the December quarter of 2023 (ABS 2024e), an increase of 780% (equivalent to an annual rate of 7.0%). As a multiple of average annual household disposable income per person aged 15 or over, the average first-home buyer mortgage has risen from 3.6 times to 9.5 times over this period.

Repayments on the average first-home buyer mortgage in the December quarter of 1991 at the then standard variable mortgage rate of 13.13% would have been $858 per month or $10,382 per annum, equivalent to 49.5% of average annual household disposable income per person aged 15 or over; by the December quarter of 2023, repayments on the average first-home buyer mortgage at the discounted variable mortgage rate of 7.31% were $4,779 per month of $58,023 per annum, equivalent to 83.9% of average annual household disposable income per person aged 15 or over (RBA 2024; moneysmart.gov.au).

The putative benefits to first-home buyers of the decline in interest rates since the early 1990s have been more than offset by the increase in property prices over the same interval. Or, to put it differently, the benefits of lower interest rates have accrued entirely to those who already owned residential property before interest rates began their trend decline, or who have subsequently bought and then sold residential properties.

The decline in home ownership rates will have at least two significant longer-term consequences.

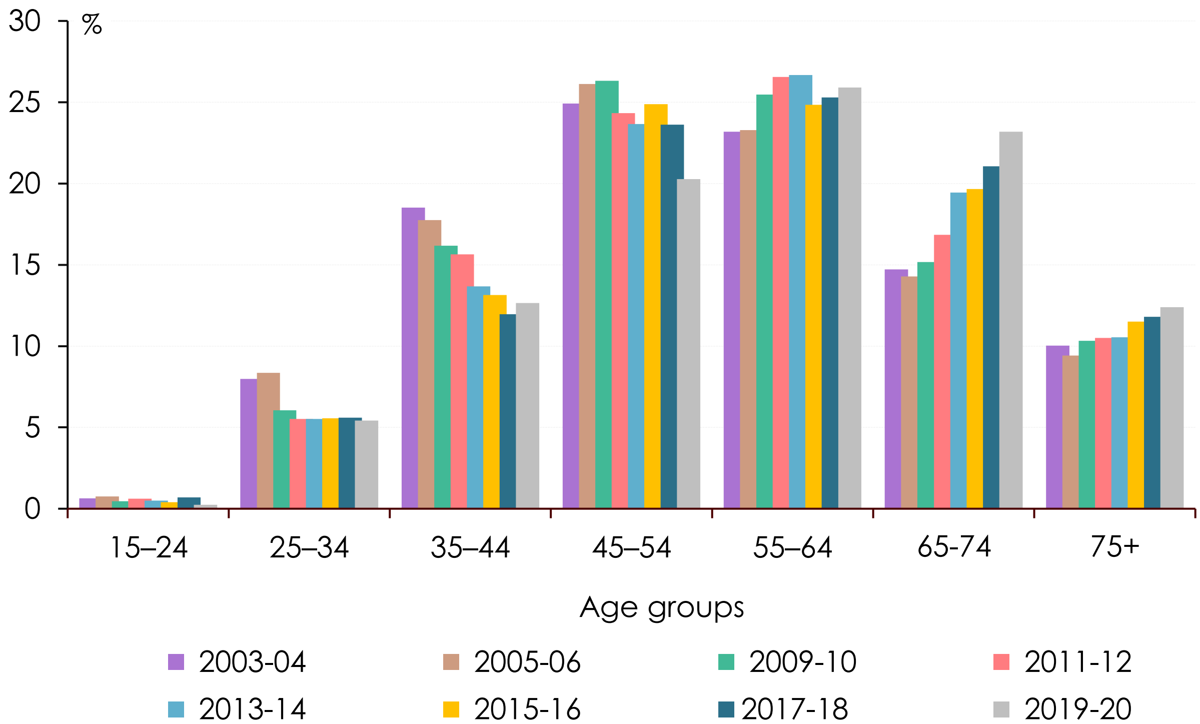
First, Australia's retirement income system has long implicitly assumed that the vast majority of retirees will have very low housing costs, because they will either own their homes outright (and hence their housing costs will consist solely of repairs and maintenance plus council rates), or will be accommodated in social housing where there rents will be fixed at a (low) percentage of their age pension, or in private rental housing supplemented by Commonwealth Rent Assistance.

That assumption has been valid for most of the post-war era, and has allowed pensions (and hence taxes) to be lower than would otherwise have been the case (all else being equal).

But it will not be valid over the medium-to-longer term. It is now virtually inevitable that an increasing proportion of Australia's population will over the next three decades enter their retirement years without having fully paid off the mortgage on their homes – in which case they will quite rationally use some or all of their superannuation savings to pay it off – or will have never attained home ownership at all – resulting in a higher proportion of the retiree population being entitled to the age pension and to Commonwealth Rent Assistance (Eslake 2017a: 15-17).

Second, the on-going decline in home ownership among Australians aged between 25 and 55 is leading to increasing inequality in the distribution of wealth across generations. While it is inevitable that older generations will be wealthier than younger ones, given that they have been in the workforce for longer and have had more time to accumulate assets and pay down debt, the *share* of total household net worth owned by households 'headed' by people aged between 25 and 54 declined by 13.1 percentage points between 2003-04 and 2019-20, while the share owned by households 'headed' by people aged over 55 has risen by 13.5 percentage points over the same period (Chart 5).

Chart 5: Shares of Australian household net worth, by age groups, 2003-04 to 2019-20



Source: ABS (2022a and previous issues); Corinna Economic Advisory.

Increasing inequality in the distribution of wealth across generations is less likely to be ameliorated by Australia's (relatively progressive, by OECD standards) tax-transfer system than increasing inequality in the distribution of income, given that wealth (and in particular, wealth held in the form of owner-occupied housing) is only lightly touched by Australia's tax system.

It seems probable that inequality in the distribution of wealth will be exacerbated by the increasing importance of inter-generational transfers as a factor in facilitating first home purchases. By one count, almost 60% of first-home buyers in the September quarter of 2021 received assistance from their parents, up from less than 10% a decade earlier (Digital Finance Analytics 2021), with around $34 billion in loans making the 'Bank of Mum and Dad' the ninth biggest mortgage lender in Australia (Hughes 2021) – although it appears to have retreated somewhat since then (Digital Finance Analytics 2023). The ongoing increase in the proportion of people who never attain home ownership means that the proportion of prospective first-time buyers who are able to access 'the Bank of Mum and Dad' will decline over time, thereby potentially accelerating the decline in home ownership rates and increasing the concentration of wealth among those who are still able to obtain this kind of assistance (Whelan et al 2023a: 44-75).

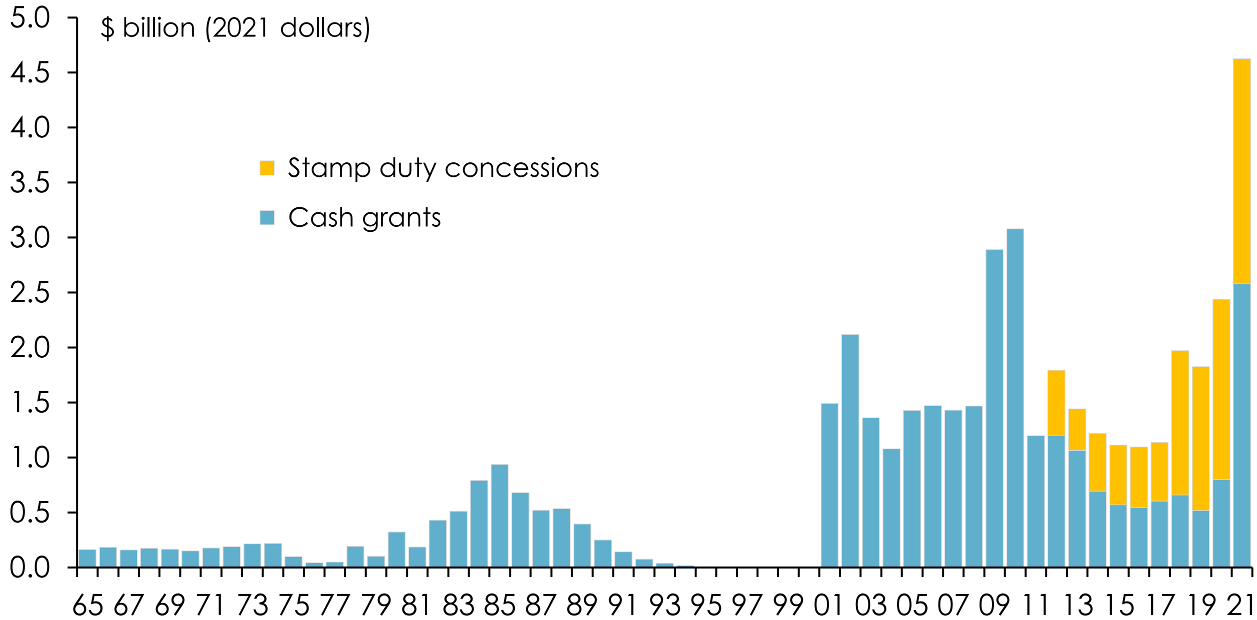
Government policy responses to the decline in home ownership rates

The substantial declines in home ownership rates among both young adults and 'middle-aged' Australians documented in the previous section has occurred notwithstanding a plethora of government programs ostensibly intended to achieve the opposite result. By one estimate, the Commonwealth, State and Territory governments spent more than $38 billion (in 2021 dollars) on cash grants to first home buyers between 1965 and 2021, and a further $9.4 billion on stamp duty concessions for first home buyers between 2012 and 2021 (Chart 6).

In fact it is probably *not* a co-incidence that the decline in home ownership rates began shortly after the commencement of the first of these schemes, the Home Savings Grant scheme introduced by the Menzies Government in 1964 in fulfilment of a promise made at the 1963 elections. This marked the beginning of a substantial and sustained (and for the most part bi-partisan) shift in government housing policies away from "the mix of supply-side and demand-side measures that characterized policy in the early post-war period" to policies that "have focussed almost exclusively on demand-side measures designed to boost the capacity of [first home buyers] to pay for housing" (Whelan et al 2023b: 4).

And this has been despite the fact that "there is a broad consensus among economists and policy makers that such measures are poorly targeted and have proved largely ineffective in arresting the systemic decline in home ownership exhibited by younger Australians" (Whelan et al 2024: 10; Pawson, Martin et al 2022: 42-44).

Chart 6: Government spending on grants to and stamp duty concessions for first home buyers, 1965-2021



Sources: Pawson, Martin et al (2022).

Australian experience over the past six decades overwhelmingly suggests that *anything* which allows Australians to spend more on housing than they would be able to otherwise – be it policy interventions by governments (such as first home owner grants, stamp duty concessions, loan guarantee schemes and the like) or other factors (such as lower interest rates and easier loan eligibility criteria on the part of mortgage lenders) – results in more expensive housing, rather than in a higher percentage of Australians owning housing.

This is especially the case in a 'supply-constrained' market – that is, one in which the demand for housing (from both owner-occupiers and investors) exceeds the supply of it – as Australia's housing market has been for most of the past three decades.

For at least the first three decades after the end of World War II, government policy (at all three levels of government, and under governments of both political complexions) was primarily focussed on increasing the supply of housing, either by constructing new housing directly (for rent to low-income 'working families' or pensioners, or for sale to families who didn't qualify for loans from private sector mortgage lenders) or by facilitating the construction of new housing by the private sector (for example by making land available for residential development, constructing transport infrastructure and other suburban amenities in new housing estates, etc.).

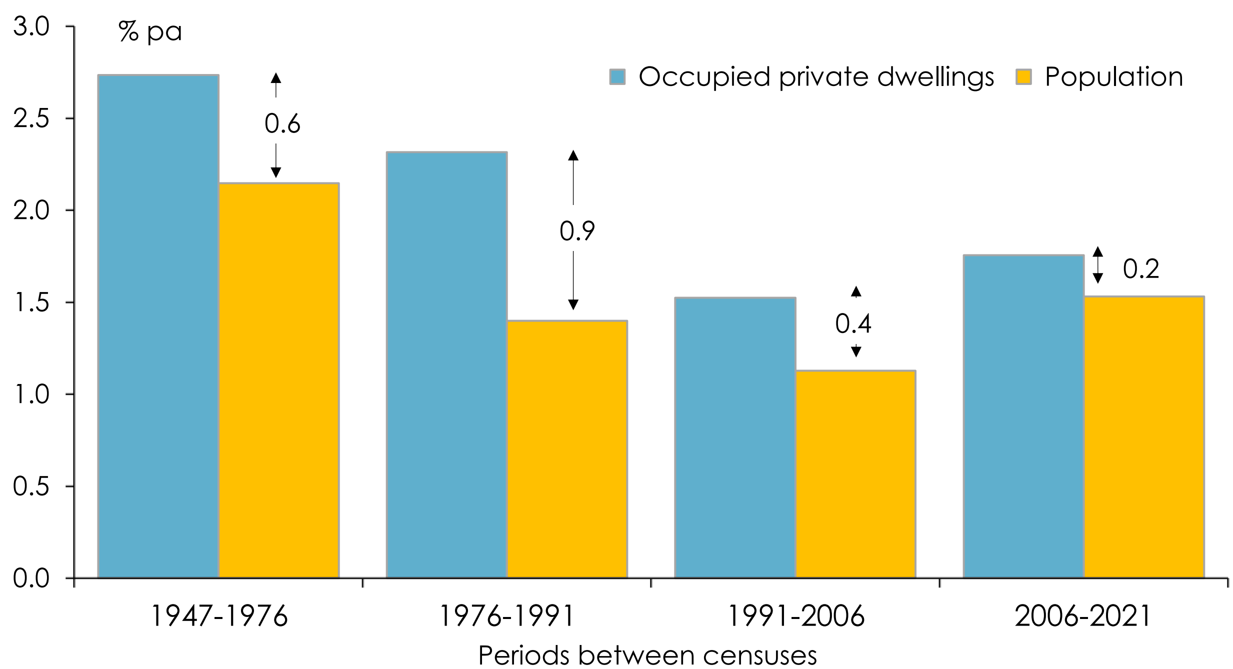
Up until the introduction of the Menzies Government's Home Savings Grant Scheme in 1964, the only government policy which had the effect of boosting the demand for housing was the immigration program (which of course was not a 'housing policy', but which inevitably and unavoidably boosted the demand for housing).

But from the mid-1980s onwards, Federal and state government policies increasingly moved away from increasing supply towards boosting demand (by making increasingly generous cash grants, with diminishingly onerous eligibility criteria, to first-home buyers, and reducing the amount of tax paid by first-home buyers and residential property investors in the form of stamp duties and capital gains tax, respectively); while state and local government policies increasingly had the effect, intentionally or otherwise, of restricting increases in housing supply and/or adding to the cost of building new housing.

Thus the number of dwelling completions by the public sector fell from an average of just over 14,000 per annum between 1955-56 and 1990-91, to just over 7,300 per annum during the 1990s, to just over 3,800 per annum during the 2000s, and after a brief upturn in the aftermath of the global financial crisis, to less than 3,000 per annum between 2012-13 and 2022-23. Conversely, spending on cash grants to first home-buyers doubled as a percentage of GDP from an average of 0.04% between 1964-65 and 1990-2000, to an average of 0.08% of GDP between 2000-01 and 2020-21.

As shown in Chart 7, the growth rate of the stock of occupied dwellings (as recorded at Censuses) exceeded that of the population by a significantly greater margin between 1947 and 1991 than it has done over the past three decades. This is especially significant given that as a result of various social changes (including smaller average family sizes, increased rates of family break-up, and population ageing), the average number of people per dwelling has fallen from over 4 in the late 1940s to less than 3 in the 2000s, implying that population growth understates the growth in 'housing demand' to a greater extent in the 21st century than it did in the third quarter of the 20th century.

Chart 7: Growth in Australia's population and stock of occupied dwellings, 1947-2021



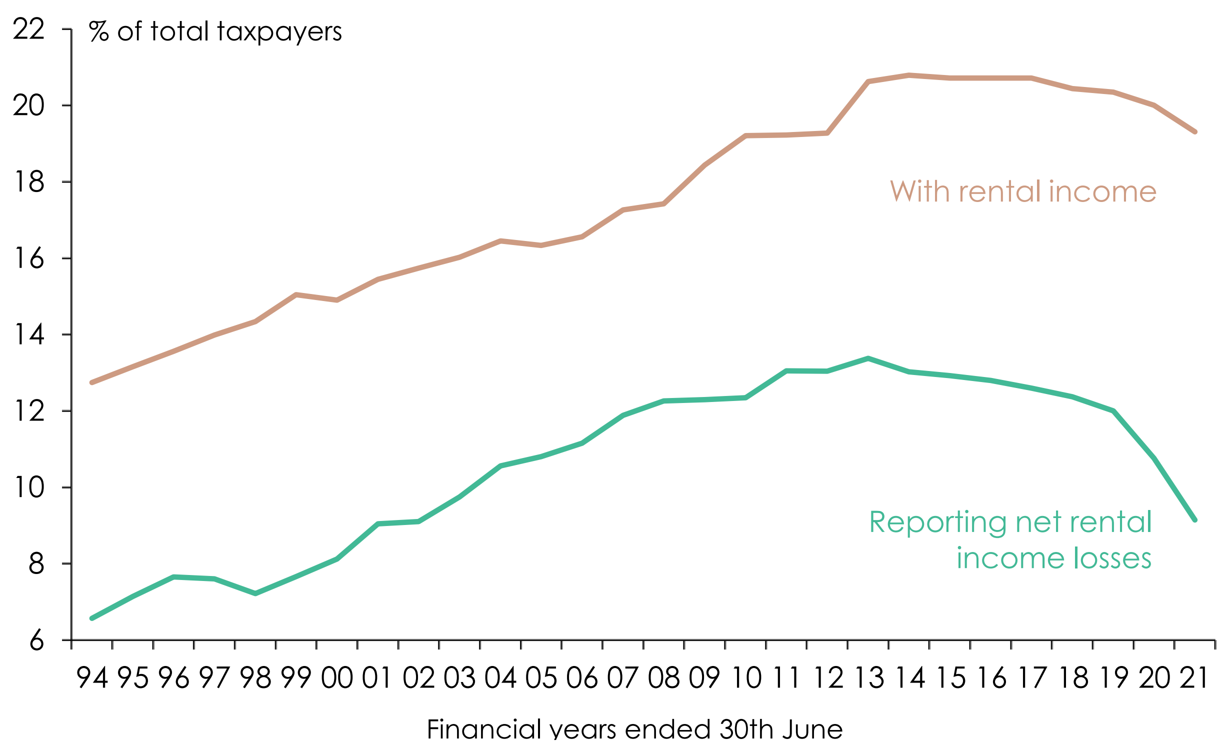
Sources: ABS (2022c and previous issues).

Additionally, prospective home-buyers have been 'squeezed' out of the market by increasing demand from property investors, who were the major beneficiaries of the changes to Australia's capital gains tax regime in 1999, whereby capital gains became taxable at half the marginal rate applicable to other income (rather than at the full marginal rate less an allowance for the impact of CPI inflation on the original purchase price, as had been the case since a capital gains tax was first introduced in 1985).

This change converted 'negative gearing' (the financing of an investment such that the interest on debt incurred in order to purchase an income-producing asset exceeds the net income from that asset in any given financial year, with the excess of interest over net debt being offset against income from other sources thereby reducing the amount of tax payable on that income) from a strategy which had hitherto served only to *defer* tax, to one which allowed those availing themselves of it both to defer *and* permanently reduce tax payable (by in effect converting wage and salary income taxable in the year in which it is earned at the taxpayer's applicable marginal rate, into capital gains taxable at a later date of the taxpayer's choosing, taxable at half the taxpayers' applicable marginal rate).

Not surprisingly, this resulted in a significant increase in the number of property investors, and a significant increase in the proportion of property investors who were 'negatively geared' (Chart 8).

Chart 8: Taxpayers with rental income, and reporting net rental income losses



Source: Australian Taxation Office (2023).

The proportion of property investors who were 'negatively geared' declined from over 70% in 2007-08 to 47.4% in 2020-21, because the substantial decline in interest rates over this period (to record lows during the Covid-19 pandemic) made it much more difficult to be 'negatively geared' (without breaching the maximum loan-to-valuation ratios stipulated by mortgage lenders). However it seems highly likely that the proportion of property investors who are 'negatively geared' will have risen substantially since 2020-21 (the latest year for which data are currently available) given the sharp rise in mortgage interest rates between May 2022 and November 2023.

It is also worth noting that although (in 2020-21) over 91% of negatively-geared property investors were *not* in the top tax bracket (and indeed over 66% had taxable incomes of less than $90,000), that is largely because over 96% of all taxpayers have taxable incomes of less than the top tax rate threshold of $180,000 (and 78% have taxable incomes of less than $90,000).

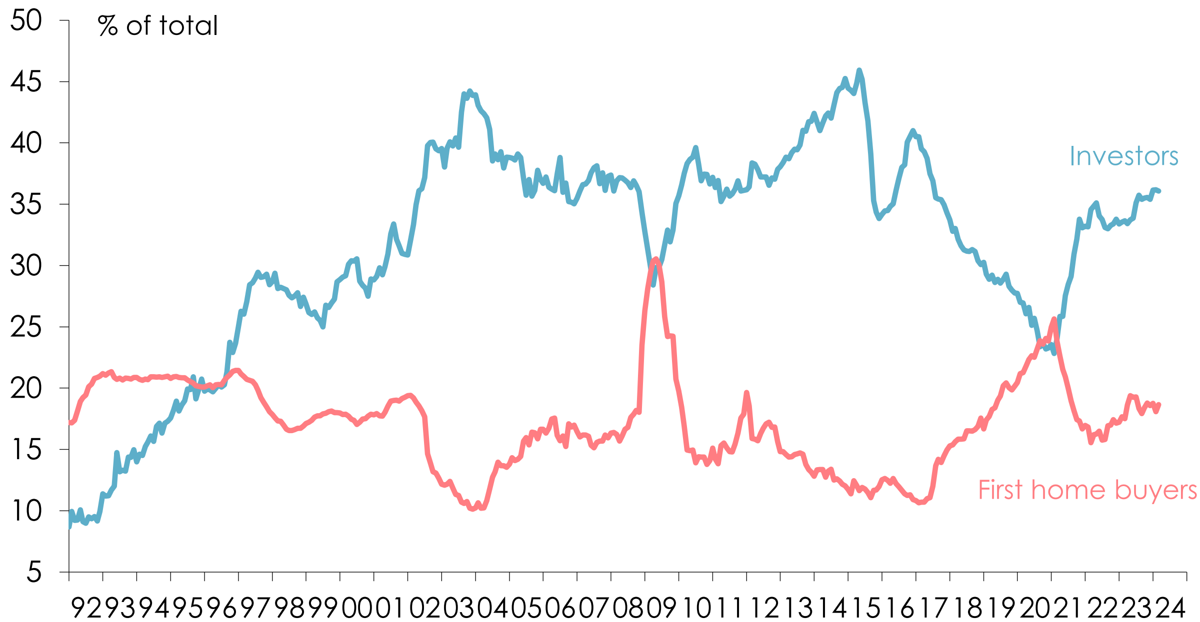
A more sensible interpretation of the distribution of negatively-geared property investors can be gained by noting that 19% of taxpayers in the top tax bracket in 2020-21 were negatively-geared property investors – compared with just 6.5% of taxpayers who were not in the top tax bracket (and 5.1% of taxpayers with taxable incomes of less than $90,000). In other words, an individual in the top tax bracket is more than three times as likely to be a negatively-geared property investor as an individual who isn't in the top tax bracket (and almost four times as likely to be a negatively-geared property investor as someone whose taxable income is less than $90,000).

The impact of the rapid growth in the number of property investors after the 1999 changes to the capital gains tax regime is also apparent from the significant increase in the proportion of mortgage finance going to investors rather than owner-occupiers (Chart 9). The share of housing finance commitments to investors rose from an average of 19.2% between 1991-92 and 1998-99, to an average of 35.2% in the years since then, peaking at over 40% in 2003-04, and again during 2016-17. Conversely the share of housing finance commitments to first-home buyers dropped from an average of 19.6% in the 1990s to 16.4% in the past 23 years, and falling to less than 12% during the periods when the share going to investors exceeded 40%.

Defenders of the generous taxation treatment of property investment argue that it is necessary to encourage investment in rental housing, and that without such generous treatment the supply of rental housing would decline, resulting in rents 'going through the roof'.

The available data suggest that the majority of property investors purchase established properties, rather than newly-built ones – which suggests that tax concessions for property investors don't do as much to increase the supply of rental housing as the foregoing assertions imply. Rather, purchases of established properties by investors add as much to the *demand* for rental housing as they do to the supply of it. And to the extent that those concessions have increased demand for housing from investors, that has been yet another factor contributing to the escalation of property prices.

Chart 9: First-home buyers' and investors' shares of total housing finance commitments



Source: ABS (2024e).

Conclusion

It seems clear from the foregoing that effective solutions to Australia's 'housing crisis', and in particular to the decline in home ownership rates which, as noted earlier, has been a factor exacerbating the imbalance between the demand for and supply of rental housing and thus a significant contributor to the escalation in rents, must avoid further inflating the demand for housing and instead focus on boosting the supply of housing – and, in particular, 'affordable' housing.

It is hard to think of any area of widespread public concern where the same policies have been pursued for so long, in the face of such incontrovertible evidence that they have failed to achieve their ostensible objectives.

The only plausible explanation for that is that the real reasons for the housing policies which governments at all levels and of all political persuasions have pursued for so long are not the ostensible reasons.

For all the crocodile tears which politicians of all persuasions routinely shed about the difficulties facing those wishing to get their first foot on the property ladder, deep down they know that there are far more people who already own at least one property (and who therefore have a very strong interest in policies which result in continued property price inflation) than there are who don't, but who would like to (and who would prefer, at least until they succeed in their aspiration, policies which would restrain the rate of property price inflation).

And, sadly, there's no reason to think that political calculus is going to change. Nor, therefore, are the housing policies which have resulted in created the housing system which Australia has today.

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Atttachment 1: Essay published in ***Pearls and Irritations***, 2nd May 2017

Once upon a time, from the late 1950s until the mid-1980s, Australia had one of the highest rates of home ownership in the world. That hadn't always been the case. From the time of federation until after the end of World War II, the proportion of Australians owning their own homes had been fairly steady at just over 50%.

But between the Censuses of 1947 and 1961, Australia's home ownership rate rose by more than 17 percentage points, from 52.6% to 69.9%. By the 1966 Census, it had reached 72.5%. As John Howard has observed, this "was a measure of the success [Sir Robert] Menzies had in delivering a sense of prosperity and stability to middle-class Australians [and] one of the explanations for his continued political success".

The unprecedented expansion in home ownership during the Menzies years is all the more remarkable for having occurred in the face of a large and sustained increase in Australia's population, averaging 2.2% per annum between 1949 and 1966 - and in particular, in the population of Australia's capital cities, which grew by an average of 3.4% per annum over this period. That's twice the rate at which the population of our capital cities has growth over the past seventeen years.

It occurred because governments – Commonwealth and State – paid at least as much attention to expanding the supply of housing as they did to supporting the demand for it.

Successive Commonwealth Governments assisted would-be home buyers by providing access to finance directly through the War Service Home Loans Scheme and, after 1956, indirectly through building societies as part of the Commonwealth-State Housing Agreement.

But they also sought actively and directly to boost the supply of housing, both by building dwellings themselves (for rent and for sale) as well as by encouraging and facilitating the construction of new dwellings by the private sector. Between the 1947 and 1966 Censuses, Australia's population grew by 53% - but the stock of housing increased by 67%. Largely because supply outpaced demand, housing prices actually declined relative to incomes during this period: John Howard notes that the number of weeks' work at an average wage required to purchase a median-priced house in an Australian capital city declined from 301 in 1950 to 200 in 1955, and remained at that level through to 1970.

The 1966 Census represented the high water mark for home ownership in Australia. Since then, the home ownership rate has gradually drifted down to 67.0% at the most recent Census in 2011 – the lowest at any Census since 1954, and lower than all but eight of 35 OECD countries according to the Reserve Bank (the 2016 Census results, to be released on 27th June will likely show a further decline, based on findings from the ABS' biennial Survey of Income and Housing).

Moreover, the 5.5 pc point decline in the aggregate home ownership rate since 1966 conceals much larger declines in home ownership, not only among the archetypal first home buyers in their mid-to-late 20s or early 30s, but among people up to their mid-50s.

In particular, since 1991 the home ownership rate among people aged 25-34 has fallen by 9 pc points, to 47% (having fallen by 5 pc points over the preceding 10 years); among people aged 35-44 by 10 pc points, to 64%; and among people aged 45-54 by 8 pc points, to 73%. But the effects of these quite large declines has been largely offset by the increase in the proportion of the population aged 55 and over, among whom the home ownership rate dropped by only 5 pc points between 1991 and 2011.

The decline in home ownership rates reflects a combination of demographic, social and economic factors – not all of which should be seen as cause for regret, or needing remediation. The decline in home ownership among 25-34 year-olds, for example, began in the early 1980s, and reflects (among other things) a gradual reversal of the immediate post-war decline in the age of first marriage and parenting, and an increase in the length of time spent in formal education compared with previous generations. There is no reason why government policy should seek to counter these trends.

However, it seems unarguable that the larger part of the decline in home ownership, especially among people aged between 35 and 55, since the early 1990s is the direct result of the ongoing deterioration in housing affordability – best summarized by the rise in average capital city dwelling prices from between 2 and 3 times average household disposable income in the 1980s to around 5 times average household disposable income since the early 2000s, the reverse of the trend which John Howard found so admirable about the Menzies era.

Fundamentally, this rise in the price of capital city housing relative to incomes is the result of the demand for housing rising at a much faster rate than the supply of it, over an extended period.

The demand for housing has been materially boosted by Australia's relatively high immigration intake, especially since the turn of the century – which has been both a result of and a contributor to our economic performance; and by the substantial decline in interest rates since the early 1990s – which for most of this period was also regarded as a measure of successful economic policies (until more recently when it has become an indicator of the failure of other measures aimed at boosting economic growth).

But these are not the only factors which have inflated the demand for housing. Ever since the mid-1960s, when the Menzies Government introduced the Home Savings Grant Scheme at the suggestion of the New South Wales Young Liberals (whose President at the time was John Howard), policy responses to perceived difficulties in attaining home ownership have taken the form of measures which allow people to spend more on housing than they otherwise would – that is, on increasing the demand for housing – rather than, as they did prior to the mid-1960s, on increasing the supply of housing.

Nowhere has this been more apparent than with regard to the demand for housing as an investment asset, as distinct from a place of abode.

In the early 1990s, first home buyers and residential property investors each accounted for about 18% of total housing finance commitments (with the remaining 64% going to existing home owners 'trading up' to their second or subsequent home). By 2014-15 the share of housing finance commitments going to first home buyers had fallen to less than 10%, while the share going to investors had risen to more than 50%. Over the same period, the number of first home buyers as a proportion of the population aged between 20 and 64 fell from over 0.9% to less than 0.7%; while the proportion of taxpayers who are landlords rose from less than 10% to more than 15%.

There could be no more compelling evidence of the way in which first home buyers have been, in effect, 'squeezed out' of the housing market by investors – a clear case, if ever there were one, of 'supply [of rental housing] creating its own demand'.

While the decline in interest rates and an easing in the criteria used in making and pricing loans to investors have played a significant part in expanding the demand for residential property as an investment, policy decisions – in particular, the change to the capital gains tax regime in 1999 and the 2007 decision to allow self-managed superannuation funds to borrow in order to purchase property – have also played a key role.

This might not have been a problem if the majority of property investment were directed into new housing – thereby boosting supply. But since the early 2000s more than 90% of lending to property investors has been for the purchase of established housing (compared with less than 75% in the early 1990s). The overwhelming effect of this increase in the flow of funds into residential property investment has therefore been to inflate prices, rather than to boost the supply of housing.

Successive federal governments have long been aware of the role that property investors have played in pushing up prices. But the only investors they have been willing to deflect away from bidding up the price of existing housing towards increasing the supply of new housing have been foreign investors – and even then, regulations intended to enforce that objective have been at best only loosely enforced, until quite recently.

Meanwhile, state and local governments – particularly, though not exclusively, in New South Wales – have pursued policies which have had the effect of constraining supply (by preventing land which might otherwise have been used to provide new housing from being thus used, or adding to the cost and time involved in redeveloping established areas at higher densities) and/or adding to the cost of providing new housing (by funding the provision of urban infrastructure through 'up-front' charges on developers instead of, as had previously been more commonplace, through local government borrowings subsequently serviced and repaid out of increases in rate revenue).

In addition, under-investment by state governments in urban transport, both public transport and arterial roads, has (as the Governor of the Reserve Bank noted in April), "pushed housing prices up", by adding to the premium attaching to housing from which employment and entertainment options are more readily accessible.

How concerned should we be about these developments?

There are at least four reasons for being concerned about the decline in home ownership rates, to the extent that it is involuntary rather than the result of 'lifestyle choices'.

First, to the extent that people still believe, as Menzies did, that "one of the best instincts in us is that which induces us to have one little piece of earth with a house and a garden which is ours, to which we can withdraw, in which we can be among our friends, into which no stranger may come against our will", then it should be troubling that a growing proportion of Australians are unable to realize those "best instincts".

Second, since Australia's retirement income system has long implicitly assumed that the vast majority of retirees will have close to zero housing costs, the fact that a diminishing proportion of Australians will own their own homes in retirement (combined with the fact that an increasing proportion of those who have attained home ownership by the time they reach retirement will need to use their superannuation savings, in whole or in part, to discharge their outstanding mortgage debt) means either that more Australians will experience greater insecurity in retirement, or there will be greater pressure to lift the rate of the age pension, or both.

Third, the inability of a growing proportion of Australians to attain home ownership is contributing to a widening in the inequality in the distribution of wealth between those who own property and those who don't (from an average of $517,000 per household in 2003-04 to $907,000 per household in 2013-14).

Fourth, to the extent that the principal source of finance for starting a small business is the ungeared equity in a home, the decline in home ownership rates (and the decline in outright ownership) should be a source of concern for those who believe, as the Liberal and National Parties do, that there is something inherently more noble about starting and running a small business than there is about working for a large one (or for a government agency).

To the extent that these concerns are widely shared, what can be done? Treasurer Scott Morrison is certainly right in emphasizing that "there are no single or easy solutions" – even though he (and others on his side of politics) tend to ignore this advice in emphasizing 'supply-side solutions' and decrying any suggestion of policy measures which are intended to dampen demand, especially from investors.

But there is wisdom in the saying, attributed to (among others) Will Rogers and Denis Healey: "when you're in a hole, stop digging". In the context of Australian housing policy, what this means is that governments should:

- at the very least, don't adopt any more policies that would further inflate demand (as allowing people to draw down their superannuation savings in order to purchase a first home would do) or further constrain supply;
- retreat (gradually, if necessary) from existing policies which inflate demand or constrain supply; and
- pursue policies which would have the effect of increasing supply, but in so doing seek to ensure that the increased supply is of the *type* or *types* and in the *locations* that are in greatest demand.

It's worth emphasizing that a strategy which embraces all of these areas requires a sustained commitment from *all* levels of government – Commonwealth, state and local – working towards the *same* ultimate objectives, rather than (as so often in recent decades) at cross purposes.

More specifically, the Commonwealth Government should:

- reduce the competition prospective home-buyers face from domestic investors by modifying the way in which the income tax system treats investors' borrowing costs and/or the way it treats capital gains;
- reduce the competition prospective home-buyers face from domestic investors by requiring APRA further to lower its 'ceiling' on the rate of growth in aggregate lending to residential property investors, and/or further tightening the criteria used by mortgage lenders in making residential property investment lending decisions;
- reduce the competition prospective home-buyers face from foreign investors by further tightening FIRB rules governing the circumstances under which foreign investors are permitted to purchase established dwellings, and/or bringing real estate agents within the purview of anti-money laundering rules and AUSTRAC reporting requirements;
- add to housing supply by including owner-occupied housing in the assets test for the aged pension, while lifting the assets test thresholds to account for the inclusion of the family home, and pressuring State and Territory Governments to exempt pensioners from stamp duty when 'downsizing';
- provide grants or low-interest loans to State and Territory Governments for the construction of more new affordable rental dwellings, either by State and Territory housing authorities or community housing organizations (as previous federal governments have done);
- provide tax incentives for institutional or individual investment in new affordable rental housing (perhaps funded by reductions in existing tax incentives for speculative investment in established housing);
- provide support (in the form of loan guarantees or interest subsidies) for borrowings by community housing organizations and other not-for-profit providers of affordable rental housing; and

- use fiscal policy more actively, when economic conditions require measures aimed at boosting economic activity or employment, so as to reduce the need to rely predominantly on monetary policy (in the form of low interest rates) for that purpose.

State and Territory Governments can contribute towards enhancing people's capacity to become home-owners by:

- scaling back cash grants and tax exemptions or concessions for first-time buyers which simply allow buyers to pay more to vendors than they otherwise would;
- replacing stamp duties with a more broadly-based land tax (with no exemptions for owner-occupied land, but with appropriate transitional provisions to avoid 'double taxation' of recent purchasers) so as to eliminate the disincentives which stamp duties create for people to 'move home' as their needs change, as well as to provide State and Territory Governments with a more predictable and stable source of revenues;
- reducing up-front taxes and charges on land developers and builders for the provision of suburban infrastructure, permits and inspections (or simply revenue-raising) – whilst recouping revenue foregone through increased municipal rates or land tax, and working with the ACCC to ensure that reductions in up-front taxes and charges are passed on to new home buyers;
- reforming planning laws to reduce the scope for frivolous or vexatious objections to redevelopment of existing residential sites at higher densities; and
- increasing investment in urban transport infrastructure to improve access to and from new suburbs to places of employment, entertainment and recreation.

State and Territory Governments could also:

- improve the supply of affordable rental housing by building more of it themselves, or by funding community and not-for-profit housing providers to do so (including by transferring some of their existing housing stock to such organizations, allowing them to leverage it in ways that State and Territory Governments have become unwilling to do);
- make unused or under-utilized state-owned land available for the provision of more affordable rental housing; and
- provide support for borrowings by community and not-for-profit affordable housing providers in the same way as suggested for the Commonwealth above.

A program of measures along these lines shouldn't be beyond the range of what is politically possible. Indeed, most of it has been done before, in the 1950s and 60s – and the evidence from that period is that *it worked*, delivering affordable housing to a rising proportion of a population that was growing more rapidly than it is today.

Moreover, the evidence strongly suggests that what governments have been doing (or failing to do) over the last years *hasn't worked* – unless you believe that it has been an unspoken, yet bipartisan, objective to transfer wealth to those who already own property from those who don't.

If governments continue to do what they've been doing, or failing to do, in the housing policy space for the last fifty years, then Australia is likely to become a very different, and less comfortable, place than most Australians have wanted it to be.

Atttachment 2: Submission to the Senate Economics References Committee's Inquiry into Affordable Housing, 23rd December 2015

Housing is important. It meets a variety of deeply personal needs, including those for shelter and (ideally) security. It provides a sense of attachment (the place where we live) and, for many people, contributes to their sense of identity. These are pretty basic needs for almost all of us, as human beings. In addition, for many people, it is an important means of building wealth (and often the most important one); and for some, it provides the foundation for starting a business.

In Australia, most of us are well-housed – at least in a physical sense. Although it hasn't always been the case, and it isn't the case for all Australians today (not least for Indigenous people), most of us live in houses or apartments that are well-constructed, amply fitted with various devices that make the accomplishment of household tasks easier than it was in our great-grandparents' day, and replete with other appurtenances and chattels that in some way or other provide us with enjoyment or add meaning to our lives.

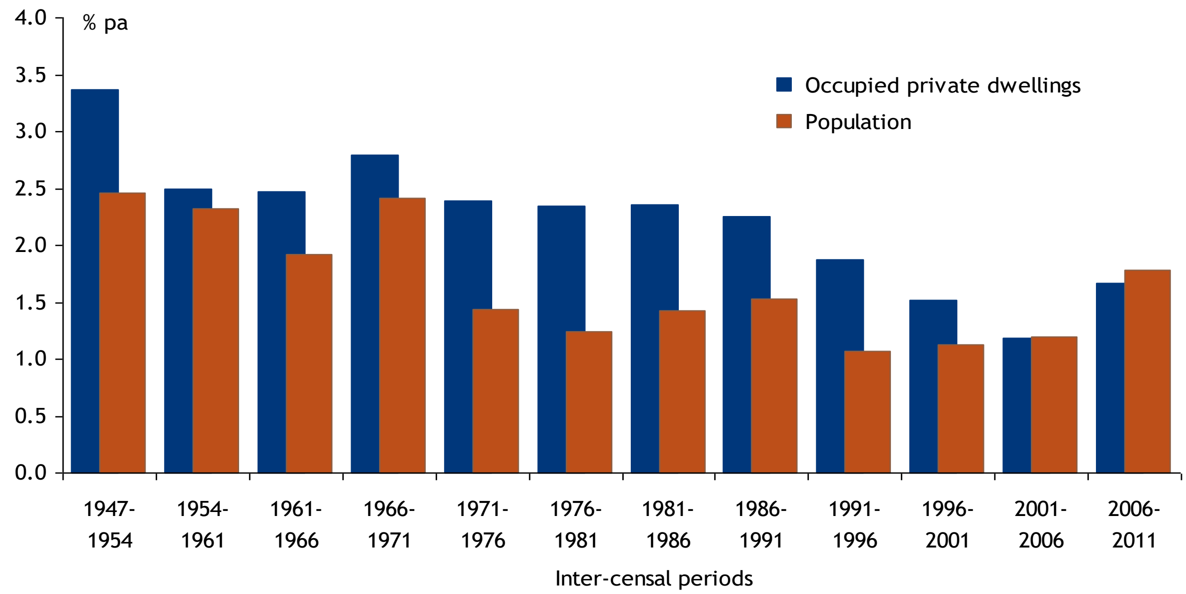
Reflecting the importance of housing to people's well-being, as well as to many broader objectives, Australian Governments of all political persuasions have long purported to attach a great deal of significance to goals such as promoting home ownership, improving housing affordability, and increasing housing supply.

And, once upon a time, Australian Governments did actually pursue policies that promoted those objectives (see Charts 1 and 2):

- between 1947 and 1961, the housing stock increased by 50% - compared with a 41% increase in Australia's population over this period. The Commonwealth and State Governments directly contributed 221,700, or 24% of the total increase in the housing stock over this period, through programs financed under the Commonwealth-State Housing Agreements, or under the War and Defence Service Homes Schemes.
- during this period, the home ownership rate increased from 53.4% to 70.3% - the largest increase in home ownership in Australia's history.
- between 1961 and 1976, the housing stock increased by a further 46% - again outstripping the 33% increase in Australia's population over this period. During this period, the Commonwealth and State Governments directly added a further 299,000 dwellings to the housing stock, equivalent to 23% of the increase in the total housing stock over this period.
- during this period, the home ownership rate fluctuated between 68% and 71%, but remained at a high level by international standards.

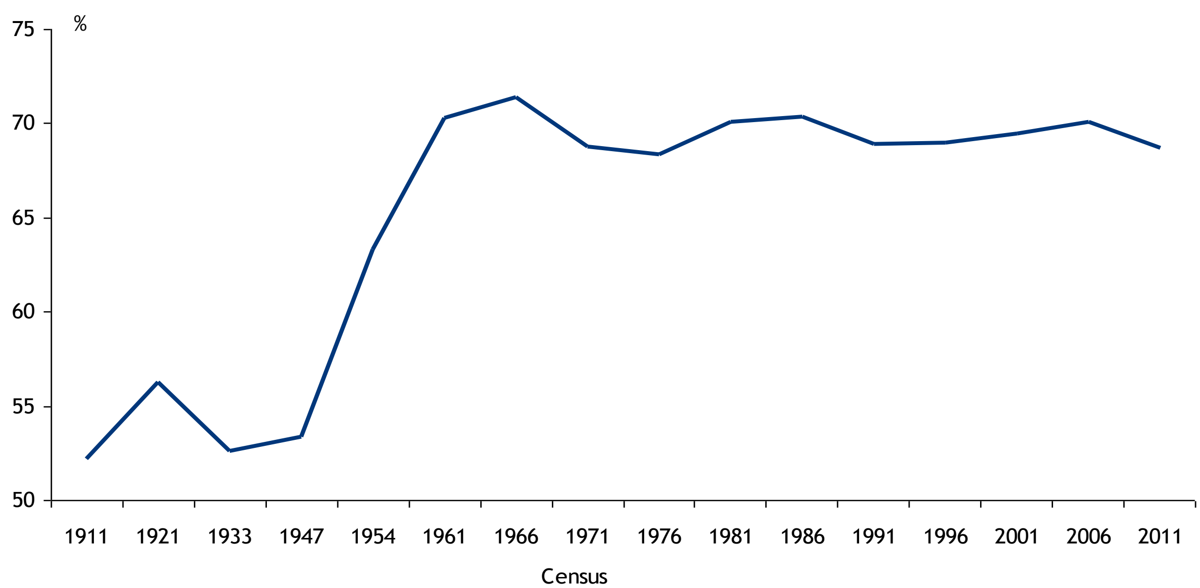
In other words, during this period, Federal and State Government housing policies were principally directed towards increasing the supply of housing, and at increasing or maintaining home ownership rates. And these policies actually achieved those objectives.

Chart 1: Growth in the population and housing stock, 1947-2011



Sources: Australian Bureau of Statistics, Census results; author's calculations.

Chart 2: Home ownership rates at Censuses, 1947-2011



Note: percentages are of occupied private dwellings excluding those for which tenure is not stated.
Sources: Advisory Council for Intergovernment Relations, *Australian Housing Policy and Intergovernmental Relations*, Discussion Paper No. 14 (1982), Appendix B, Table B4; Tony Kryger, *Home Ownership in Australia - Data and Trends*, Parliamentary Library Research Paper No, 21 (February 2009), Table 1; Australian Bureau of Statistics, *2011 Census Quickstats*.

There were downsides to these policies, of course – in particular, many of the dwellings built by State housing authorities, and by the private sector, were poorly located from the standpoint of access to employment, lacked basic infrastructure and community services, and inadvertently served to concentrate socio-economic disadvantage.

But they did ensure that a rapidly-growing population was at least adequately housed, and they gave many families an opportunity to gain a first foothold on the home ownership ladder that they would otherwise not have had.

Even between 1976 and 1991, the housing stock increased at a much faster rate – 41% - than the population – 23% - although only 9% of dwelling completions during this period were by the public sector.

The relationship between growth in the housing stock and population growth began to change after the early 1990s. Between 1991 and 2001, Australia's population grew by 11.5%, while the housing stock grew by only 18.3% - less than 9 pc points more than the population. And between 2001 and 2011, while the population grew by 16%, the housing stock grew by only 15.2%. That is, over the past decade, the housing stock has grown at a slower rate than the population – for the first time since the end of World War II.

This gradual narrowing in the 'gap' between the growth rate of the housing stock and that of the population – to the point of eliminating it entirely over the past decade – has come in the face of demographic trends that would have warranted a widening of this gap:

- average family sizes declined between the early 1960s and the early 1990s, implying that more dwellings are required to accommodate the same number of people;
- family breakdowns have meant that more dwellings are required to accommodate the same number of people; and
- population ageing has resulted in more people living alone, again increasing the number of dwellings required to accommodate the same number of people.

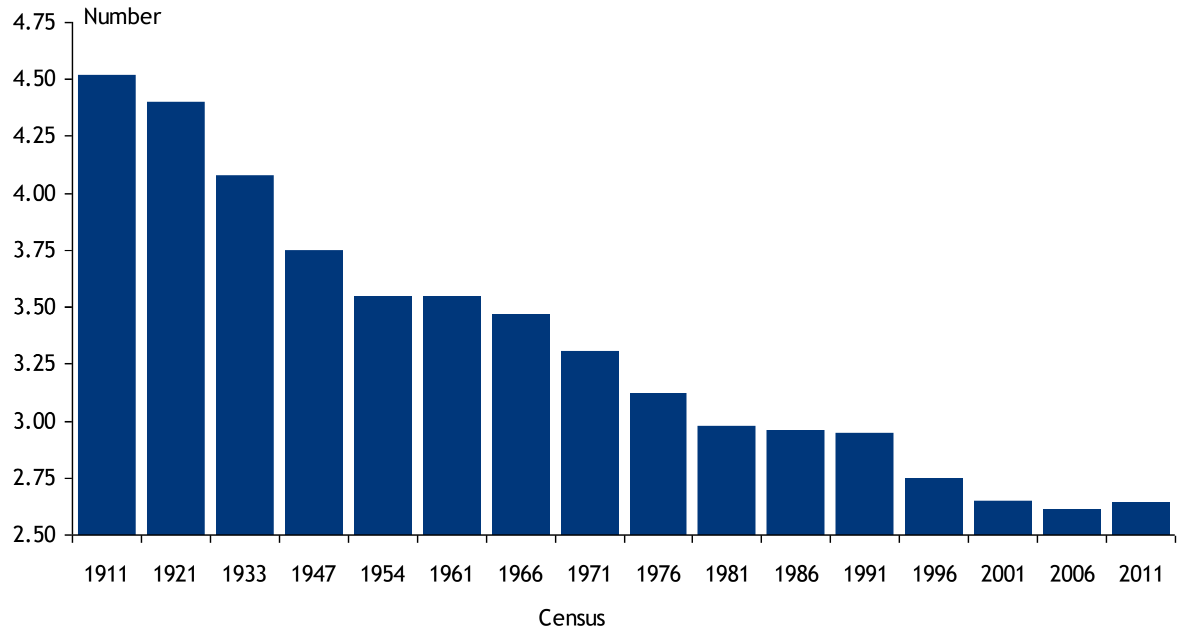
Yet, in the face of these ongoing trends, the average number of people per dwelling actually rose (from 2.61 to 2.64) between the 2006 and 2011 Censuses – for the first time in at least 100 years (since the first Commonwealth Census was conducted in 1911 – see Chart 3). From 1911 to 2006, the average number of people per dwelling had fallen from 4.52 to 2.61. It would seem that the widespread angst among 'baby boomer' parents about how difficult it is to get their 20- (and in some cases 30-) something children out of the family home has a sound basis in fact.

This is what the National Housing Supply Council, of which I'm a member, means when it estimates that Australia has a 'shortage' of housing relative to the 'underlying' demand for it – a shortage which it last estimated to be of the order of 228,000 dwellings as at 30 June 2011 (NHSC 2012: 24-25).

That 228,000 figure is *not* an estimate of the number of homeless people in Australia (which the ABS put at just over 105,000, a number which included 41,390 people living in 'severely overcrowded' dwellings, at the 2011 Census – ABS 2012). Rather, it reflects the gap between the existing housing stock, and what the Council estimates the stock would need to be if household formation patterns had remained essentially unchanged over the past decade.

In passing, I should note that these estimates pre-date the results of the 2011 Census, which has resulted in some downward revisions to the estimated *level* of Australia's population compared with those which had been based on extrapolations from the 2006 Census, and which will lead to some consequential revisions to these estimates of the housing 'shortage'.

Chart 3: Average number of people per dwelling at Censuses, 1911-2011



Sources: Advisory Council for Intergovernment Relations, *Australian Housing Policy and Intergovernmental Relations*, Discussion Paper No. 14 (1982), Appendix B, Table B3; Australian Bureau of Statistics, *2011 Census Quickstats* and earlier Census reports.

However, it would be a mistake to think – as some other commentators have – that the revisions prompted by the 2011 Census results have eliminated the 'housing shortage' which the National Housing Supply Council and others had previously identified (see NHSC 2013: 107-123).

Nor, in my view, is the idea that there is a 'housing shortage' in the sense intended by the NHSC contradicted by the work that Philip Soos has undertaken for Earthsharing Australia, using data from Melbourne water suppliers to show that up to 6% of residential properties across the Melbourne metropolitan area may have been vacant during the second half of 2011 (Soos 2012). If those vacant properties aren't available (for whatever reason) for sale or rent then their existence does not detract from the existence of a housing shortage – although it may well be, as Philip argues, that an increase in land tax could prompt at least some of the owners of those properties to make them available for sale or rent.

I think there are two principal reasons for the increasing failure of the stock of housing to grow at a rate commensurate with the growth rate (and changing needs) of the population:

First, the direct contribution of the public sector to growing the housing stock has declined substantially. From the mid-1950s to the mid-1970s, public sector agencies completed an average of 15,512 new dwellings per annum (and they indirectly financed the completion of another 3,600 dwellings annually through low-interest loan schemes). From the mid-1970s to the early 1990s, they completed an average of 12,379 new dwellings per annum. But since then, they have completed an average of less than 6,000 new dwellings per annum (indeed between 1999 and 2009 the public sector built fewer than 4,000 new dwellings per annum, on average).

Second, state and local government planning schemes and policies for charging for the provision of suburban infrastructure have made it increasingly difficult for the private sector to supply new housing, especially at the more affordable end of the spectrum.

This second reason has three distinct dimensions.

- First, state and local authorities have imposed increasingly more onerous requirements on developers for the provision of infrastructure and services in new housing estates. While that undoubtedly represents 'progress' in many respects – and certainly adds to the amenity of 'greenfields' developments from the perspective of those who move into them – it comes at a cost.
- Second, local authorities have changed the way in which this infrastructure and these services are provided, from a model based on paying for them largely through debt, which was then serviced and repaid out of subsequent increases in rate revenues, to one based on paying for them through 'up front charges' on developers.

  While this is consistent with a 'user pays' philosophy, and appeases the growing voter aversion to public debt, it has meant (especially in New South Wales, where developer charges have risen to much higher levels than in other States) that developers find it increasingly difficult to produce house-and-land packages at prices which are affordable for first-time buyers and still make a profit, so they have reacted by building a smaller number of more expensive houses targeted at the trade-up market.
- Third, metropolitan planning authorities and inner-city local governments have made it increasingly more time-consuming and onerous to undertake higher-density or 'infill' developments on 'brownfields' sites – in particular by imposing tighter planning controls, and by providing more opportunities for objections to and appeals against planning decisions.

As with the more onerous requirements for infrastructure provision in 'greenfields' sites, there are two sides to this story, and I have a lot of sympathy with the desire of residents in established areas to prevent developments which detract materially from their quality of life (and/or from the value of their properties). But whatever perspective one might take on that debate, there is no doubt that developments in planning law have contributed to the mis-match between housing demand and housing supply.

What is also noticeable about the last twenty years is that – despite mortgage interest rates having been substantially lower, on average, over this period (7.59% pa over the past 20 years, compared with 11.95% over the preceding 20), and despite unprecedented expenditure on grants to first home buyers – the overall home ownership rate has actually *declined* by 5 percentage points, to 67% at the 2011 Census, its lowest figure since the 1954 Census (refer back to Chart 2).

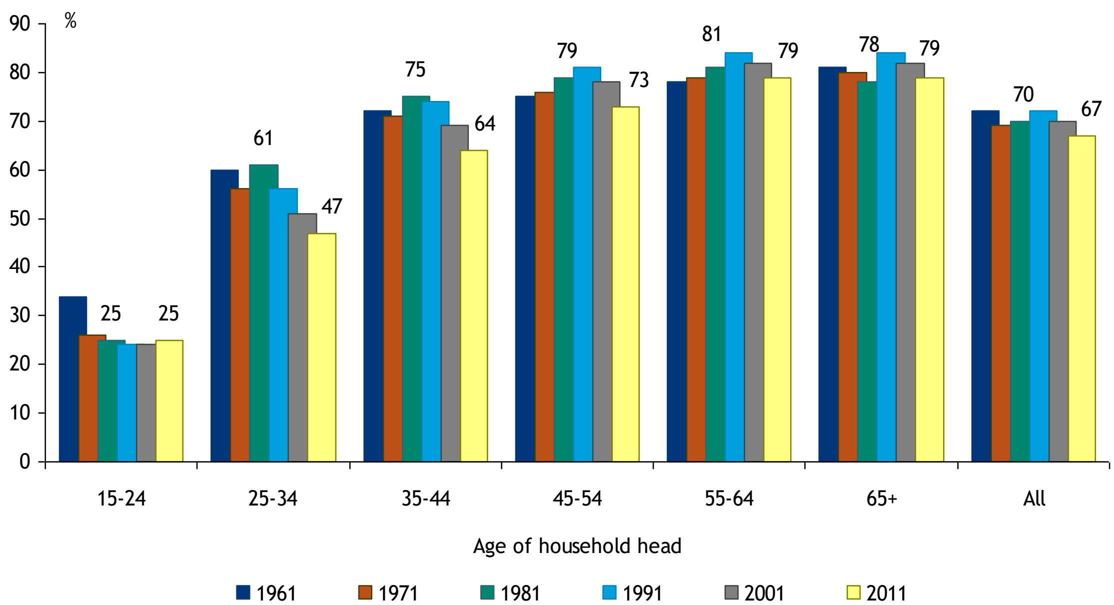
The decline in home ownership has been *even more* pronounced when one 'looks through' the effects of the ageing of the population, which (among other things) means that an increasing proportion of the population is within age groups where home ownership rates are always (and for obvious reasons) higher than in younger age cohorts.

Home ownership rates among younger age groups declined dramatically between the 1991 and 2011 Censuses – from 56% to 47% among 25-34 year-olds; from 75% to 64% among 35-44 year-olds; from 81% to 73% among 45-54 year-olds; and 84% to 79% among those over 55. In fact, the only age cohort among whom home ownership rates *didn't* decline over the past 20 years was 15-24 year-olds: but that was only because their home ownership rate had already fallen from 34% in 1961 to 24% by 1991 and didn't decline any further (Chart 4).

The decline in home ownership rates among younger age groups is almost certainly due in part to changing preferences (including partnering and having children at older ages, and greater importance attached to proximity to employment or entertainment venues): but it also undoubtedly owes more to declining affordability.

This is also evident in the fact that home-owners are taking longer to pay off their mortgages. According to the ABS' just-released *Survey of Housing Occupancy and Costs* (ABS 2013b), only 45.8% of home-owning households owned their home outright in 2011-12, compared with 58.5% in 1994-95.

Chart 4: Home ownership rates by age cohort, 19961-2011



Sources: Judith Yates, Hal Kendig & Ben Phillips, *Sustaining Fair Shares: the Australian Housing System and Intergenerational Sustainability*, AHURI Final Report No. 2011 (February 2008); updated for 2011 Census Results by Judith Yates, communication to author.

This may be partly due to the fact that households can, and do, use mortgages for other purposes apart from simply acquiring the property which is mortgaged: but I think it is far more due to the fact that people need to borrow much more money initially in order to acquire a property now than they did 20 years ago.

So, when set against the stated objectives of the housing policies pursued by successive governments of various political persuasions, the results have been dismal.

Although most Australians are, as I noted at the beginning, physically *well* housed, it can no longer be said that we are, in general, *affordably* housed; nor can it be said that the 'housing system' is meeting the needs and aspirations of as large a proportion of Australians as it did a quarter of a century ago. And in making that assertion I am thinking of the extent to which the housing system meets the needs and aspirations of those who don't want, or can't and won't ever be able to, become home-owners, as well as of those who do seek that status.

Assistance to first home buyers

It's hard to think of any government policy that has been pursued for so long, in the face of such incontrovertible evidence that it doesn't work, than the policy of giving cash to first home buyers in the belief that doing so will promote home ownership.

The Commonwealth Government started giving cash grants to first home buyers in 1964 when, at the urging of the New South Wales Division of the Young Liberal Movement (whose President at the time was a young John Howard), the Menzies Government began paying Home Savings Grants of up to $500 to 'married or engaged couples under the age of 36' on the basis of $1 for every $3 saved in an 'approved form' (generally, with a financial institution whose major business was lending for housing) in the three years prior to buying their first home, provided that the home was valued at no more than $14,000.

This scheme was abolished by the Whitlam Government in 1973 (in favour of an income tax deduction for mortgage interest payments by persons with a taxable income of less than $14,000 per annum); re-introduced under the name of Home Deposit Assistance Grants (without the age or marriage requirements and the value limits, and with a larger maximum grant of $2,500) by the Fraser Government in 1976; replaced by the Hawke Government in 1983 with the First Home Owners Assistance Scheme, initially with a maximum grant of $7,000 (later reduced to $6,000) and subject to an income test; abolished by the Hawke Government in 1990; and then re-introduced as the First Home Owners Grant (FHOG) by the Howard Government in 2000, without any income test or upper limit on the purchase price of homes acquired, ostensibly as 'compensation' for the introduction of the GST (even though the GST only applied to the purchase of new homes, and not to existing dwellings which the majority of first-time buyers purchase).

In this guise it was really just the first of what became an explosion in 'status-based welfare' payments to selected groups irrespective of needs during that decade.

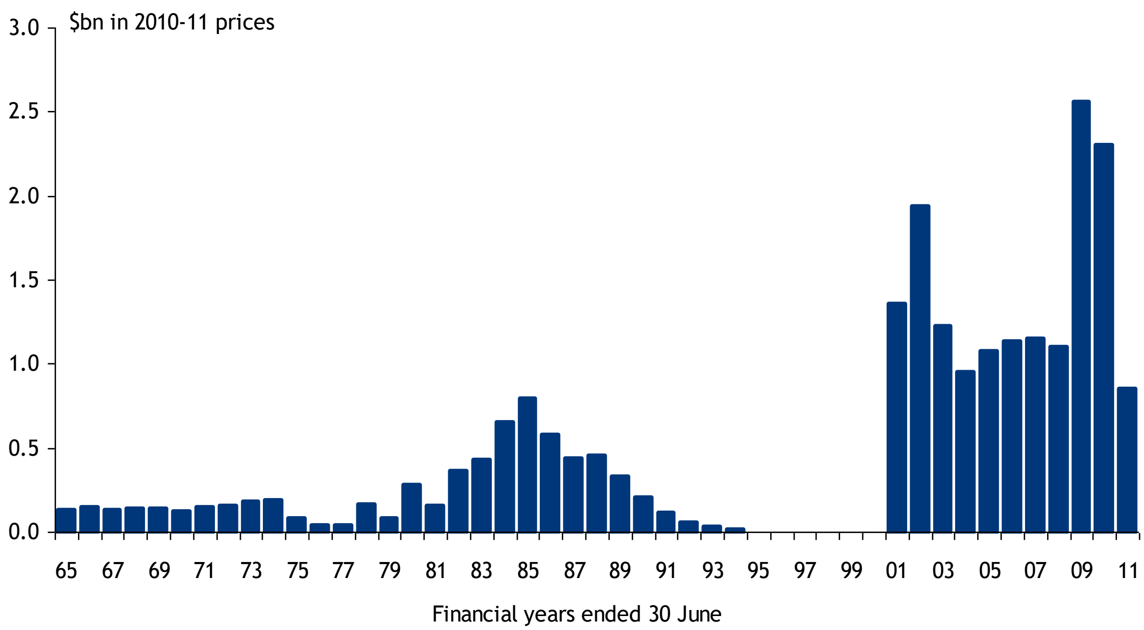
On two occasions since 2000, the FHOG has been temporarily increased in response to an actual or feared slump in housing activity (and in 2008, in response to a feared decline in house prices).

Over the past decade, most State and Territory Governments have 'topped up' the basic FHOG payments to first-time buyers with grants from their own resources, with some States providing even larger grants to buyers meeting certain additional criteria (for example, the Victorian Government provided an additional $5,000 for buyers of new homes in rural and regional areas).

I estimate that the Commonwealth, State and Territory Governments spent a total of $22.5bn (in 2010-11 dollar values) on cash grants to first home buyers between 1964 and 2011 (see Chart 5 below).

State and Territory Government also provide indirect financial assistance to first-time buyers by partially or totally exempting them from the stamp duty they would otherwise pay on their purchases. In 2011-12 alone, these were worth around $3bn.

Chart 5: Spending on cash assistance to first home buyers, 1964-65 to 2011-12



Note: expenditures shown are calculated as nominal values deflated by All Groups CPI.
Sources: Advisory Council for Intergovernment Relations, *Australian Housing Policy and Intergovernmental Relations*, Discussion Paper No. 14 (1982), Appendix G, Tables G5 & G6; Australian Government, Budget Paper No. 1, *Budget Statements*, 1983-84 through 1994-95; Commonwealth Grants Commission, *2008 Update Report* (Attachment D) and *Report on GST Revenue Sharing Relativities, 2010 Review* Volume 2; CoAG Reform Council, National Affordable Housing Agreement: Performance Reports 2009-10 and 2010—11.

Governments have thus been providing cash handouts to first-time home-buyers for almost half a century. Yet, as I mentioned earlier, the overall home ownership rate has never been higher than it was at the 1961 Census, immediately before governments started going down this path; and among the age groups which are supposedly most intended to benefit from these handouts, home ownership rates have declined almost vertiginously over the past two decades.

And it's pretty obvious why. Cash grants and other forms of assistance to first-time home buyers have served simply to exacerbate the already substantial imbalance between the underlying demand for housing and the supply of it.

In those circumstances, cash handouts for first home buyers have simply added to upward pressure on housing prices, enriching vendors (and making those who already housing feel richer) whilst doing precisely nothing to assist young people (or anybody else) into home ownership. For that reason, I often think that these grants should be called 'Existing Home Vendors' Grants' – because that's where the money ends up – rather than First Home Owners' Grants.

Encouragingly, perhaps – after what in my case has been more than 30 years of putting this kind of argument – State and Territory Governments appear at last to have gotten this message. Over the past 18 months or so, every State and Territory Government has either abolished or at least substantially reduced grants to first home buyers who buy existing dwellings, whilst increasing their grants to those who buy new ones, with a net effect of reducing the total spend on assistance to first home buyers.

I have no doubt that some of the increased grants to first time buyers of new homes will end up boosting developers' or builders' profits: but I accept that at least some of it will induce a supply side response to any resulting increase in demand for new homes, while considerably fewer taxpayers' dollars will be wasted inflating the prices of existing homes.

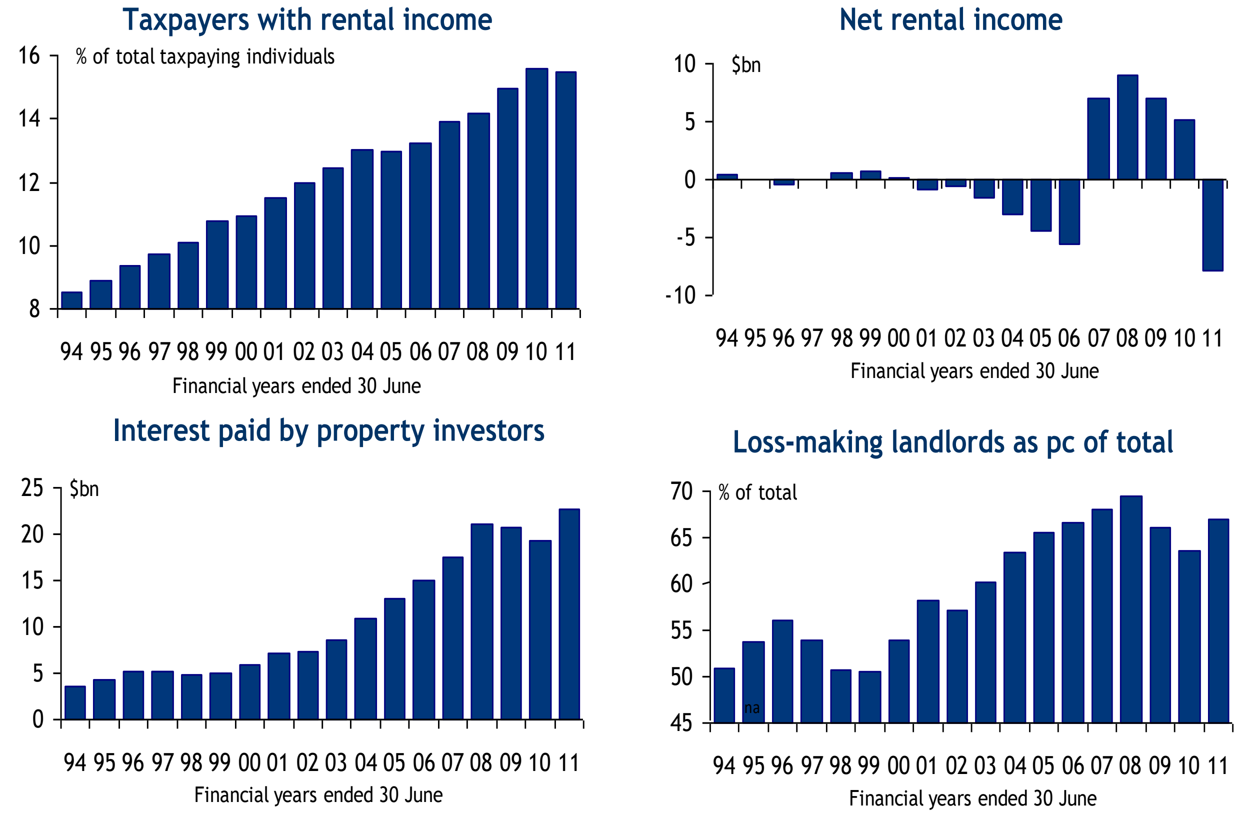
'Negative gearing'

Another long-standing policy which I have long argued has not only failed to deliver on its oft-stated rationale of boosting the supply of housing – in this case for rent – but has actually exacerbated the mis-match between the demand for and the supply of housing, as well as having distorted the allocation of capital, and undermined the equity and integrity of the income tax system, is so-called 'negative gearing'.

It is perhaps a telling indication of just how generous Australia's tax system is to investors in this regard, compared with those of other countries, that one usually needs to explain to foreigners what the term 'negative gearing' actually means (see for example RBA 2003: 40-45).

'Negative gearing' originally allowed taxpayers in effect to defer tax on their wage and salary income (until they sold the property or shares which they had acquired with borrowed money, on which they were paying more in interest than they received by way of dividends or rent). However, after the Howard Government's 1999 decision to tax capital gains at half the rate applicable to other income (instead of taxing inflation-adjusted capital gains at a taxpayer's full marginal rate), 'negative gearing' became a vehicle for permanently reducing, as well as deferring, personal tax liabilities. And the availability of depreciation on buildings adds to the way in which 'negative gearing' converts ordinary income taxable at full rates into capital gains taxable at half rates.

Chart 6: 'Negative gearing', 1993-94 to 2010-11



Sources: Australian Taxation Office, *Taxation Statistics 2010-11* (latest available); author's calculations.

It's therefore hardly surprising that 'negative gearing' has become much more widespread over the past decade, and much more costly in terms of the revenue thereby foregone (see Chart 6).

In 1998-99, when capital gains were last taxed at the same rate as other types of income (less an allowance for inflation), Australia had 1.3 million tax-paying landlords who in total made a taxable profit of almost $700mn.

By 2010-11, the latest year for which statistics are presently available, the number of tax-paying landlords had risen to over 1.8mn (or 14% of the total number of individual taxpayers), but they collectively lost more than $7.8bn, largely because the amount they paid out in interest rose more than fourfold (from just over $5bn to almost $23bn over this period), while the amount they collected in rent 'only' slightly less than trebled (from $11bn to $30bn), as did other (non-interest) expenses.

If all of the 1.2mn landlords who in total reported net losses in 2010-11 were in the 38% income tax bracket, their ability to offset those losses against their other taxable income would have cost over $5bn in revenue foregone; to the extent that some of them are in the top tax bracket then the revenue loss is obviously higher.

This is a pretty large subsidy from people who are working and saving to people who are borrowing and speculating (since those landlords who are making 'running losses' on their property investments expect to more than make up those losses through capital gains when they eventually sell them).

And it's hard to think of any worthwhile public policy purpose which is served by it. It certainly does nothing to increase the supply of housing, since the vast majority of landlords buy established properties: 92% of all borrowing by residential property investors over the past decade has been for the purchase of established dwellings, as against about 72% of all borrowing by owner-occupiers.

Precisely for that reason, the availability of 'negative gearing' contributes to upward pressure on the prices of established dwellings, and thus diminishes housing affordability for would-be home buyers.

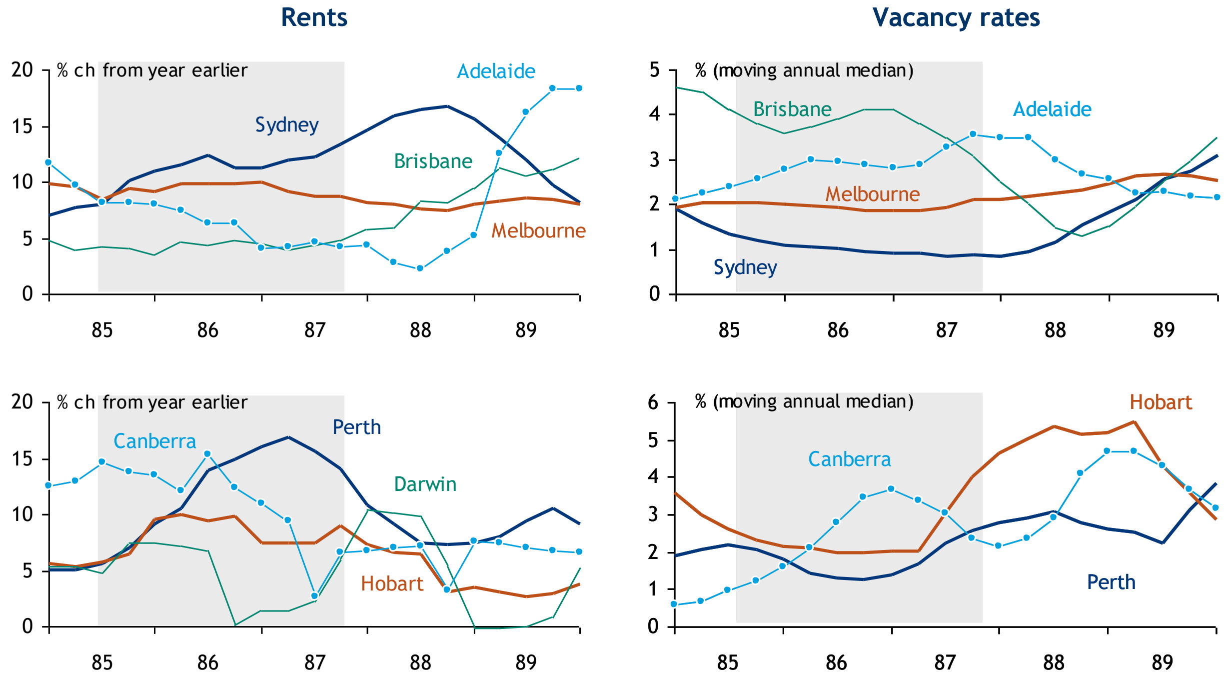
Supporters of 'negative gearing' argue that its abolition would lead to a 'landlord's strike', driving up rents and exacerbating the existing shortage of affordable rental housing. They repeatedly point to what they allege happened when the Hawke Government abolished negative gearing (only for property investment) in 1986 – that it 'led' (so they say) to a surge in rents, which prompted the reintroduction of 'negative gearing' in 1988.

This assertion is actually *not true*. If the abolition of 'negative gearing' had led to a 'landlord's strike', as proponents of 'negative gearing' repeatedly assert, then rents should have risen everywhere (since 'negative gearing' had been available everywhere). In fact, rents (as measured in the consumer price index) only rose rapidly (at double-digit rates) in Sydney and Perth – and that was because in those two cities, rental vacancy rates were unusually low (in Sydney's case, barely above 1%) before negative gearing was abolished. In other State capitals (where vacancy rates were higher), growth in rentals was either unchanged or, in Melbourne, actually slowed (see Chart 7).

However, notwithstanding this history, suppose that a large number of landlords were to respond to the abolition of 'negative gearing' by selling their properties. That would push down the prices of investment properties, making them more affordable to would-be home buyers, allowing more of them to become home-owners, and thereby reducing the demand for rental properties in almost exactly the same proportion as the reduction in the supply of them. It's actually quite difficult to think of anything that would do *more* to improve affordability conditions for would-be homebuyers than the abolition of 'negative gearing'.

There's no evidence to support the assertion made by proponents of the continued existence of 'negative gearing' that it results in more rental housing being available than would be the case were it to be abolished (even though the Henry Review appears to have swallowed this assertion).

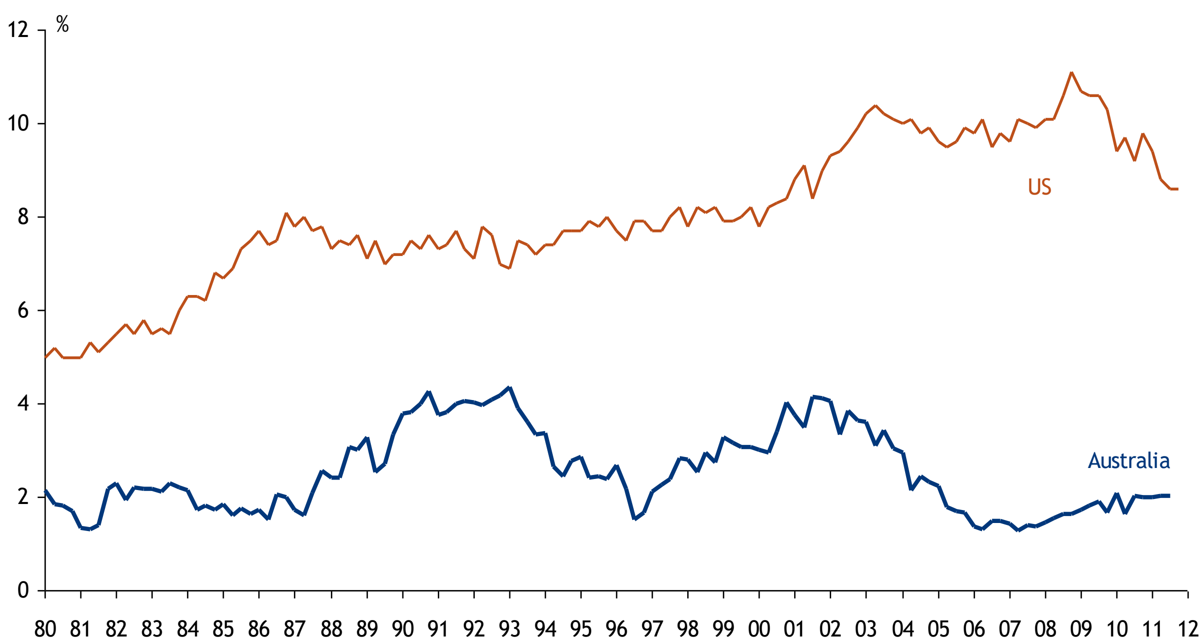
Chart 7: Rents and vacancy rates in the mid-1980s



Note: Shaded area denotes the period (from July 1985 until September 1987) in which negative gearing was not available for property investments. *Sources*: ABS; Real Estate Institute of Australia.

Most other 'advanced' economies don't have 'negative gearing': yet most other countries have higher rental vacancy rates than Australia does.

Chart 8: Rental vacancy rates in Australia and the United States



Sources: Real Estate Institute of Australia; US National Association of Realtors.

In the United States, which hasn't allowed 'negative gearing' since the mid-1980s, the rental vacancy rate has in the last 50 years only once been below 5% (and that was in the March quarter of 1979); in the ten years prior to the onset of the most recent recession, it has averaged 9.1% (see Chart 8 above).

Yet here in Australia, which does allow 'negative gearing', the rental vacancy rate has never (at least in the last 30 years) been above 5%, and in the period since 'negative gearing' became more attractive (as a result of the halving of the capital gains tax rate) has fallen from over 3% to less than 2%.

During that same period, rents rose at rate 0.8 percentage points per annum faster than the CPI as a whole; whereas over the preceding decade, rents rose at exactly the same rate as the CPI.

Similarly, countries which have *never* had 'negative gearing' – such as Germany, France, the Netherlands, the Nordic countries and (low-tax) Switzerland – have much larger private rental markets than Australia.

Some supporters of negative gearing also argue that since businesses can deduct all of the operating expenses they incur (including interest) against their profits in order to determine their taxable income, and can also 'carry forward' net losses incurred in any given year against profits earned in subsequent years so as to reduce the tax otherwise payable, it is only 'fair and reasonable' that investors should be able to do the same.

There are two flaws in this argument, in my view. First, a large part of the appeal of 'negative gearing' comes from the way in which it allows income which would otherwise have been taxed at the investor's marginal rate effectively to be converted into capital gains, which are taxed at half the investor's marginal rate. Businesses – if they are incorporated, as most businesses these days are – can't do that. Companies aren't eligible for the 50% discount on tax payable on gains on assets held for more than one year.

Second, while individuals are allowed to deduct expenses incurred in connection with producing investment income from their taxable income, they aren't allowed to deduct many types of expenses incurred in producing wage and salary income.

To take an obvious example, wage and salary earners aren't allowed to deduct the cost of travelling to and from work; nor are they allowed to deduct child care expenses.

Or, to take another example which may be an even closer analogy with 'negative gearing' for investment purposes, individuals aren't allowed to deduct interest on borrowings undertaken to finance their own education as a tax deduction, even though that additional education may contribute materially to enhancing their future earnings – and even though any such additional future earnings will be taxed at that individual's full marginal rate, as opposed to half that rate in the case of capital gains on an investment asset.

Let me be clear that I'm not advocating that 'negative gearing' be abolished for property investments only, as happened between 1986 and 1988. That would be unfair to property investors.

Personally, I think 'negative gearing' should be abolished for all investors, so that interest expenses would only be deductible in any given year up to the amount of investment income earned in that year, with any excess 'carried forward' against the ultimate capital gains tax liability, rather than being used to reduce the tax payable on wage and salary or other income (as is the case in the United States and most other 'advanced' economies).

But I'd settle for the recommendation of the Henry Review (2009, Volume 1: 72-75), which was that only 40% of interest (and other expenses) associated with investments be allowed as a deduction, and that capital gains (and other forms of investment income, including interest on deposits) be taxed at 60% (rather than 50% as at present) of the rates applicable to the same amounts of wage and salary income.

This recommendation would not amount to the abolition of 'negative gearing'; it would just make it less generous than it is at the moment. It would be likely, as the Henry Review suggested, 'to change investor demand toward housing with higher rental yields and longer investment horizons [and] may result in a more stable housing market, as the current incentive for investors to chase large capital gains in housing would be reduced'.

I could even accept the Henry Review's recommendation that "these reforms should only be adopted following reforms to the supply of housing and reforms to housing assistance' which it makes elsewhere, even though I disagree with the Henry Review's concern that these reforms 'may in the short term reduce residential property investment'.

I could also accept, grudgingly, that any of these changes could be 'grandfathered', in order to minimize opposition from those who already have negatively geared investments, and who would understandably see the modification or removal of 'negative gearing' without such a provision as directly disadvantageous to them.

However, the alacrity with which both major political parties moved to distance themselves from even these modest proposals in the Henry Review when it finally saw the light of day a few days before the 2009 Budget doesn't provide much grounds for hope in that regard.

What could be done instead?

I've argued that two of the principal long-standing government interventions in the housing market – cash assistance to first-time home buyers and 'negative gearing' – have *not only failed* to achieve their stated objectives, but have actually *exacerbated* the difficulties facing those whom these interventions are supposed to assist:

- they have served to *inflate the demand* for housing – and in particular, the demand for already-existing housing – whilst doing *next to nothing* to increase the supply of housing.
- they have therefore *made housing affordability worse*, not better.
- and to the extent that the ownership of residential real estate is concentrated among higher income groups – 36% of all property owned by individuals, and 47% of all property other than owner-occupied dwellings, is owned by households in the top 20% of the income distribution (ABS 2013c) – they *exacerbate inequities* in the distribution of income and wealth.

In passing, it is perhaps worth wondering why successive governments of various political persuasions have been so unwilling to alter policies which have not merely failed so abjectly to meet their stated objectives, but have demonstrably had such an adverse impact on those whom successive governments repeatedly assert they are keen to assist.

At the risk of appearing cynical – not that, in my experience, being cynical about the motivations of political parties and governments carries a serious risk of leading one into making erroneous predictions about what they might be– I think the answer is obvious. While political parties and governments profess to care about first home buyers, the reality is that in a typical year fewer than 100,000 people succeed in attaining home ownership for the first time; whereas there are some 5.8 million households (and over 8 million people) who already own at least one property. Hence there are 100,000 votes for policies which might result in lower house prices, and over 8 million votes against policies which might result in lower house prices (or in favour of policies which result in higher house prices). As the Americans say: 'do the math'.

John Howard – who could 'do the math' better than most – often used to say that no-one ever came up to him complaining about the increase in the value of their home, or asking him to do things that would reduce the value of their homes so that younger people could buy them more readily.

Nonetheless, if by some chance a political party really did want to advocate and implement policies that really would stand some chance of improving the capacity of the Australian housing system to respond to the needs and aspirations of Australian citizens, what might they say?

The fundamental change that such a set of policies might embody would be a switch from policies which inflate the demand for housing to policies which boost the supply of housing. Such a suite of policies might include some or all of the following:

- first, the abolition of all existing policies which serve only to increase the prices of existing dwellings, such as cash grants to and stamp duty exemptions for first time buyers, and 'negative gearing' for investors (in all assets, not just property, and if politically necessary, only for assets acquired after the date on which such a policy was announced);

- second, the redirection of the funds thereby saved (and/or the additional revenue raised) towards programs that increase the supply of housing – for example, by directly funding the construction of new dwellings (as the Rudd Government did as part of its response to the global financial crisis), or by providing some combination of grants, loans or tax incentives to induce private sector developers to increase the proportion of 'affordable' dwellings within their developments, whether for sale or rental;
- third, expanding or replicating programs like Western Australia's 'Key start' scheme which assist eligible people to become home owners on a 'shared equity' basis, with eligibility being subject to a means test, and which creates a 'revolving fund' as the 'shared equity' is returned to the State Government upon sale;
- fourth, changes to the way in which State and Territory Governments tax holdings of and transactions in land, with a view to encouraging more efficient use of it. That would include replacing stamp duty on land transfers (which are 'bad' taxes on many grounds, including that they discourage people from changing their dwellings as their needs change) with more broadly-based land taxes (ie, no exemptions for owner-occupiers, but with appropriate transitional provisions) and possibly higher rates for undeveloped vacant land in established urban areas;
- fifth, taking a more 'holistic' view of urban infrastructure investment, by recognizing that it has an important housing dimension – that is, that public (or private) investment in transport infrastructure (both public transport and roads) can make a tangible contribution towards improving housing supply and affordability by making 'greenfields' developments more accessible to both buyers and renters – and considering funding such infrastructure by levies on the increments to the value of the land which result from such investments (as for example with the levy that funded the Melbourne Underground Rail Loop Authority in the 1970s and early 1980s);
- sixth, revisiting current models for financing the provision of infrastructure and services in 'greenfields' housing estates with a view to reducing the extent to which these are funded by 'upfront' charges (something which could be assisted by changes to the land tax regime which I mentioned a moment ago); and
- seventh, reducing the cost, complexity and regulatory uncertainty associated with 'brownfields' and 'infill' developments in established areas – which doesn't have to mean traducing the property rights of other property owners, but which should mean clearer and more uniform planning rules, with fewer opportunities for frivolous or vexatious objections and appeals.

Note that I am *not* advocating something that is often widely assumed to find favour with economists – namely, the removal of the exemption of owner-occupied housing from capital gains tax. I *don't* favour that, because consistency with other parts of the tax system would require that mortgage interest payments be deductible. That would in turn almost certainly encourage people to take on more debt, and would thus inflate the demand for housing, putting further upward pressure on prices. And it could well end up being revenue negative.

Sadly, however, the political calculus to which I referred earlier means that there is probably less chance of any of these proposals being taken up – let alone all of them – than there is of Andrew Demetriou calling a press conference to announce that Tasmania really should have its own team in the Australian Football League. Politics – more than any other single factor – means that Australians are likely to have to live with a dysfunctional housing system for a long time yet to come.

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