# AFTER THE HOUSE PRICE BOOM

## Is this the end of the Australian dream?

Housing has become less affordable, but policy changes could alleviate the problem, explains **Peter Saunders**

The house price bubble has finally burst. Average house prices more than doubled between 1996 and 2004, but according to one source, Sydney prices fell back by 15% during 2004, with Melbourne 11% down.[2]

While it lasted, the boom added substantially to the wealth of existing home owners, but it has made home ownership more expensive for aspiring new buyers. In its aftermath, three questions arise. First, who financed the capital gains that home owners have enjoyed? Second, has home ownership become unaffordable for the younger generation? And third, what, if anything, should the government be doing to help young families get onto the home ownership ladder?

### Home ownership and wealth accumulation

In October 2004, *The Sydney Morning Herald* announced that total private wealth had doubled in just seven years to an average of $250,000 for every man, woman and child in the country.[3] One factor driving this wealth explosion has been the buoyant share market, for the share price index has almost doubled since 1996, increasing the personal wealth of everyone with money in a superannuation fund as well those who invest directly in shares.[4] But more important than the rising share market was the housing boom.

Around two-thirds of households own their own home, either outright or on mortgage. Housing comprises nearly 55% of all household assets and almost three-quarters of the assets of the median household.[5] For most Australians, housing is a much more important asset than share ownership, and the doubling of house prices had a major impact on personal wealth holdings.

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It is sometimes argued that capital gains from the housing market do not represent 'real' increases in personal wealth because owners cannot get their hands on the money, and even if they sell, the cash has immediately to be reinvested in another property which has inflated at the same rate. But capital gains create real wealth differences, irrespective of whether they are liquified. One of the key sociological developments of our time has been the emergence of a division between a majority of families who are accumulating wealth through home ownership, and a marginalised minority who have few assets, little material stake in their society, and no realistic prospect of accumulating wealth or passing it on to their children.[6] The average wealth difference between home owners and renters in Sydney is now estimated at $436,000.[7] This division is much deeper and more enduring than the much-debated 'gap' between high and low income groups.[8]

Moreover, home owners can and do turn their housing capital into cash. About 8% of personal income comes from equity withdrawals from housing.[9] Empty nesters trade down when their children leave home, and retirees move to cheaper areas and cash in on the price differential. Home owners who do not want to move can raise loans using their housing as collateral (40% of home owners have used the equity in their homes to raise money for discretionary spending),[10] or they can sell part of their equity in return for an income stream. They also enjoy the 'imputed rental income' that flows from having paid off their mortgage.[11] Increasing numbers of Australians also own holiday homes or rental properties which can be cashed in at any time to realise capital gains.

## House price inflation: The downside

The growth of personal wealth through the housing market has many positive effects. It means families can reduce their reliance on government and strengthen their financial and personal security. They can help their children and grandchildren get a decent start in life, they can use their assets to start up businesses or as collateral for loans, and they derive pride of ownership and an enhanced sense of personal achievement and autonomy from having a home of their own.[12]

But the sorts of capital gains we have seen in recent years also have a downside. Rapidly rising house prices make it more difficult for non-owners to get a foothold on the property ladder (a recent Productivity Commission report confirms that housing affordability declined considerably in the three years to 2004).[13] And new buyers who have purchased a home may have over-stretched themselves, for debt levels are at record heights and a future rise in interest rates could generate severe hardship.

Rapid house price inflation also has wider economic costs, for it can distort the way we use capital.[14] The Productivity Commission notes how 'Rising prices can create expectations of further price increases, unrelated to any change in market fundamentals.'[15] Young workers rush to take out huge mortgages before house prices spiral out of reach, and older buyers are seduced into investing in rental property while disregarding falling rental returns. Panic buying creates a housing 'bubble' which sucks money out of productive investments and eventually threatens the whole economy.[16]

Just as damaging in the long-term are the sociological effects of high house price inflation. The longer a housing boom goes on, the more it is likely to foster what Max Weber called a spirit of 'booty capitalism' emphasising pursuit of short-term windfall profits at the expense of hard work, thrift, enterprise and long-term planning.[17] When passive ownership of a house delivers riches far beyond what most people could accumulate from many years of working and saving, traditional virtues emphasising hard work, saving, enterprise and deferred gratification are likely to get eroded, yet these are values on which capitalist liberal democracy ultimately depends.[18] Savings, certainly, have been in free-fall. The household savings ratio, which was 10% in 1990, is now negative, and debt servicing is costing an average of 9% of personal incomes.[19]

## Is there an intergenerational conflict over housing?

The doubling of house prices since 1996 added to the wealth of established home owners, but who paid for these capital gains?

It is often assumed that new buyers finance the capital gains of existing owners, and this has led some commentators to talk of an intergenerational conflict in which older owners make capital gains by exploiting younger people struggling to enter the market.[20] The two percentage point fall in home ownership rates between 1986 and 1996, and the rise in the average age of first-time buyers,[21] are both seen as indicators that the younger generation is getting squeezed out by their avaricious elders, although the Productivity Commission suggests loan approvals for first time buyers have been fairly constant over the last ten years, and that the rising average age of first purchase is more a function of lifestyle changes than of reduced housing affordability.[22]

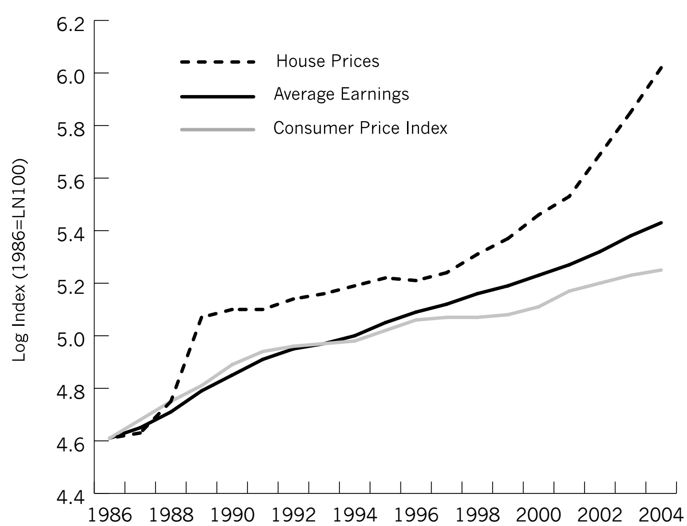
In fact, capital gains accruing to one generation need not come at the expense of the next. In a period of economic growth, owners can make gains from rising house prices without new buyers having to pay more as a proportion of their income than previous generations did.

My analysis of earlier house price booms in Britain shows that, while each new generation of buyers paid a higher *price* for houses than previous generations did (for housing inflated faster than the CPI), they did not incur a higher *cost*, relative to their income (for housing inflated roughly in line with average wages).[23] Although older generations made capital gains from the increase in real prices, the younger generation paid no more of its income for housing than their parents did. Capital gains were accruing, not from the exploitation of new buyers, but from productivity gains in the economy as a whole.

Owners made capital gains because house prices tended to rise with wages, rather than getting cheaper over time as most other commodities do. The reason why house prices keep pace with wages and outstrip other commodity prices is mainly a result of the relative inelasticity of housing supply. Land in urban areas is inherently scarce, and this scarcity is further exacerbated by planning controls. It also takes a long time to build a house from scratch, so there is always a time-lag between a surge in demand and an increase in supply. And most of the houses that are traded each year are second-hand (only one-quarter to one-third of total annual turnover in Australia involves new houses), so even if planners release more land and the building industry quickly steps up supply, the aggregate effect on the number of houses offered for sale is muted. For all of these reasons, as wages rise, house prices tend to rise along with them.

The recent house price boom in Australia, however, does not fit this pattern. While house prices have raced ahead of the CPI, they have this time also outrun average wages. This means part of the capital gain enjoyed by home owners has accrued from growth in the economy, but part has also come (as the pessimists fear) from a real increase in the cost borne by new buyers.

### Figure 1: House prices, wages and the cost of living, 1986-2004




Sources: Australian Bureau of Statistics *House Price Indexes, Established Houses, Table 1* (641601); *Average Weekly Earnings of Employees, Table 1* (630201); *CPI All Groups, Index Numbers, Table 1B* (640101b).

Since 1986, the cost of living, measured by the CPI, has increased by 91% while average weekly earnings have increased by 128%. This 40% enhancement in real incomes can be seen in Figure 1 in the growing gap between the CPI and average earnings trend lines. But in this same period, average house prices leapt by 310%, far out-stripping the growth in real wages (this is seen in Figure 1 in the sharp divergence of the house price and average earnings trend lines). This has substantially increased the cost of housing, pushing up the ratio of average house prices to average wages from around 6:1 to 9:1.[24] This then raises the question of how the new generation of buyers has been able to afford these increased real prices.

## Why the latest boom was different

The fact that house prices have so dramatically outpaced average wage growth as well as other commodity prices makes this latest housing boom somewhat distinctive. Three factors seem to have changed.

The first (and by far the most important) is that nominal interest rates have dropped as global inflation has fallen. This has made loan repayments more affordable at any given level of income. The result is that buyers have been taking out larger loans, which has enabled them to bid more for housing, driving up prices. The main beneficiaries have been existing owners who have seen a huge, one-off increase in the value of their assets.

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Of course, lower interest rates mean that, although house prices have escalated, the mortgage repayments of new buyers may not be much higher as a proportion of their disposable incomes than they were for earlier generations. With current low interest rates, a 9:1 house price:income ratio is as affordable as a 6:1 ratio was when rates were higher. The difference, however, is that buyers today are more vulnerable than in the past.[25] If rates were to rise, many recent buyers would find themselves with mortgages they cannot afford.

Secondly, demographic changes such as increased divorce, rising immigration and delayed marriage have over time increased the number of households needing accommodation, thereby driving up demand. There has also been a steady increase in the number of women in employment, and because house prices are driven by *household* incomes rather than by individual *personal* incomes, the increased number of dual-earner households has pushed house prices higher. This has meant that single earner households now find house purchase much more expensive than it used to be, but dual earner households can still afford to buy. The latter, however, have still lost out, but this shows up in time rather than monetary budgets. Between them, couples today have to undertake more hours of paid work to achieve the same level of housing as earlier generations did.

Thirdly, housing demand (and hence the level of house prices) has in recent years been stoked up by the entry into the market of large numbers of small investors buying property to let. Loans for investment properties in Australia have increased from 20 to 40% of all housing loans in less than ten years.[26] More than one in eight taxpayers now declares a rental income, and 17% of households own an investment property.[27] This compares with just 6.5% of households in the USA and Canada and 2% in the UK.[28] As we shall see, the greater attraction of buying an investment property in Australia is probably explained by unique features of our tax system.

## How governments can make matters worse

Despite the hike in prices, many young people today can still afford to buy houses. Unlike earlier generations, however, they have (a) borrowed on the strength of two full-time incomes (so there is little scope for increasing household earnings if interest rates rise for both partners are already working); (b) taken on large loans in a low inflation climate (so they cannot depend on inflation to reduce the size of their debt as their parents did); and (c) borrowed to the hilt at low rates of interest (leaving them dangerously exposed to the possibility of even quite small rate rises in the future). It is unlikely the housing market has ever before looked quite so vulnerable.

It is important to remember that the recent price boom was not restricted to Australia. It was a global phenomenon. *The Economist* reports that by 2004, house prices had reached record levels relative to average wages in the USA, Britain, France, Ireland, the Netherlands, New Zealand and Spain as well as in Australia. Local factors like government grants and taxes were not, therefore, the major explanation for our housing boom. Nevertheless, Australian prices did go higher than in many other countries —between 1997 and 2004, average house prices here rose by 110% compared with an 18 country average rise of just 65% (prices in New Zealand rose only 51% and the USA recorded a 57% increase).[29]

Clearly, the global boom was refracted through local conditions in different countries, and this suggests that government policies here may well have had some impact. In particular, policies that inflated demand or restricted supply are likely to have pushed prices higher, and Australia does exhibit a unique combination of such policies.

*Demand boosters*

The **First Home Owner Grant** is a non-means tested federal government handout introduced in July 2000 as compensation for the imposition of GST on new housing. Although used dwellings were exempted from GST, the $7,000 grant was made available to all first-time buyers purchasing new or used properties. GST increased the cost of new houses by 10%, and many first-time buyers spent their government grants buying older homes instead. The resulting downturn in the building industry was the biggest on record, and the economy as a whole plunged into negative growth in the December 2000 quarter.[30] The federal government responded by doubling the grant for those purchasing newly-built homes, and although this enhanced grant has now been withdrawn again, all first-time buyers continue to get A$7,000 from the taxpayer.

The First Home Owner Grant has almost certainly pushed up the price of housing, for relatively inelastic supply means most of the money paid out in grants has probably been capitalised into higher house prices. The grant may have helped a small number of young, middle-income people to enter owner occupation more quickly than they would otherwise have done (for it short-cut the saving period by giving them a deposit), but it has done little for lower income groups since it leaves monthly mortgage repayments unaffected.[31]

Tax policies too have helped stoke demand. Of particular importance are the **negative gearing** rules which allow investors to set net losses against the tax they pay on earned income from other sources. This arrangement is unique to Australia and it has made property investment attractive to wage earners seeking to reduce their income tax liability. In 2000-01, housing investors deducted $700 million more in losses than they declared in rental incomes, and 58% of taxpayers declaring a rental income made a loss, receiving less in rent than they paid out in loan and management charges.[32] The cost to taxpayers of negative gearing is estimated at $1.2 billion.[33]

Negative gearing predates the recent rush into property investment, so it cannot be said to have caused it, but it will certainly have reinforced the attraction of investing in rental housing by encouraging investors to buy even when the rental returns did not justify the capital outlay. This probably explains why there have been so many more 'buy-to-let' purchases in Australia than in other countries.

Like the First Home Owner Grant, tax savings from negative gearing tend to be capitalised into the value of property prices.[34] Seen in this light, taxpayers forfeit over $1 billion of revenue every year to make houses more expensive than they would otherwise be.

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Changes to the **capital gains tax** (CGT) also inadvertently helped increase demand for housing. Until 1999, capital gains from asset sales were calculated net of inflation and were then taxed at the individual's marginal income tax rate, but in 1999, the inflation adjustment was replaced by a 50% tax-free concession on nominal gains. This meant that, if asset values rose quickly in an otherwise low inflation environment, investors would significantly reduce their tax liability as compared with the previous arrangement, and this is exactly what then happened. The reform therefore added substantially to the profits of housing investors and provided a major additional incentive to buy into housing. The Treasury is estimated to have lost $2.4 billion in 2003-04 as a result of this concession.[35]

**Stamp duties** levied by the states are likely to have depressed rather than inflated the overall level of house prices, but they have increased the costs of purchase. Stamp duties have a particularly strong effect at times of rapid inflation, for they rise proportionately as the price of housing rises, thereby exacerbating the unaffordability problem.

*Supply restrictors*

On the supply side of the market, state governments have added to the price of housing by imposing higher building standards on new housing developments, levying developer charges to cover the full cost of new infrastructure, and artificially limiting the release of land for new development. While none of these factors has had a major short-run impact on price levels, they have helped make housing less affordable over the long term.[36]

Thirty years ago, land made up about 20% of the total selling price of a new house, but today it is closer to 60%. Housing developers claim that the failure of planning agencies to match the increasing demand for land by increasing supply has raised the cost of development land, and hence the price of new housing.[37]

There has also been a change in the way new infrastructure on the urban fringe is financed, with developers now required to meet the full cost of common facilities like roads, sewerage and parks in a single upfront payment. The Productivity Commission argues that, because these higher upfront charges should be balanced by lower recurrent user charges, residents should be no worse off than before. However, the Commission concedes that capitalising these costs into a one-off upfront payment will have pushed up house prices and may therefore have made it more difficult for low-income families to get mortgages in the first place.

## Policy implications[38]

There is nothing 'wrong' with home owners accumulating capital gains; indeed, there is much to be welcomed about a process that over time enables ordinary people to build up assets which give them financial security and allow them to help their children. We should, however, be concerned if government policies add to the wealth of home owners at the expense of other taxpayers, and to limit this, some policy changes seem appropriate.

The **First Home Buyers' Grant** represents a clear case for reform. It has failed to make house purchase more accessible for lower income groups, and has probably made things worse by pushing up the price of the cheapest housing. Scrapping it would save taxpayers around $1 billion per year, and would remove one of the most blatant examples of 'middle class welfare' in the Australian tax and benefits system.[39]

We should also look again at **negative gearing** which encourages people to buy investment properties even when rental returns fail to cover their outgoings. Its attractiveness is largely a function of Australia's high marginal income tax rates, and if income taxes were radically reduced, concessions like this could be phased out.[40] This would improve allocative efficiency and simplify an over-complex tax system.[41]

Governments also need to consider how to ensure a greater supply of development land at lower cost. Planning constraints on the urban fringe have increased house prices (particularly in Sydney), and planners must recognise that their preferred strategy of raising housing densities in inner areas cannot meet all the anticipated future demand.[42] The method for charging for infrastructure associated with new housing developments should also be re-examined, for major items of community infrastructure are most fairly financed through long-term borrowing (repaid through higher rate levies on residents who benefit), as this spreads the burden across all beneficiaries, now and in the future.[43]

## Conclusion

The latest housing boom has left new and recent buyers stretched and vulnerable. There is not a lot that government can do about this, for the key factors in the boom have been the shift to low interest rates and changing demographics, and both of these are beyond the control of our politicians. But governments have had *some* influence on house prices as a result of their tax, spending and regulatory activities, and there is a strong case for reviewing policies in these areas.

The argument for abolishing the First Home Owner Grant seems compelling. There is also a pressing need to increase the release of new development land, and to change the system for financing new infrastructure. Tax changes too are warranted. In particular, negative gearing could be ended in return for a radical reduction in marginal income tax rates and a long-overdue simplification of the personal tax system.

Capital gains arising from home ownership are a major vehicle of wealth accumulation for ordinary people, but they should not be underpinned by governments at the expense of those still trying to gain access to owner-occupation.