Opening statement to the House of Representatives Economics Committee Inquiry into Home Ownership – by Saul Eslake, economist, 6th August 2015

Thank you for the invitation to speak to you today on the subject of home ownership. I appreciate it, and regard it as an honour.

Australia's home ownership rate at the last Census in 2011 (of 67.0%) was lower than at any previous Census since 1954 – although it is still 4.1 pc pts above where it was then. The overall home ownership rate fluctuated between 72% and 68% between the 1961 and 1991 censuses: but since then it has declined by 5 pc pts.

This might seem like a small decline: but it masks a much more significant development. Among households headed by people aged between 25 and 55 years, home ownership rates have declined by an average of almost 10 pc points: the effects of this on the overall home ownership rate have been partially offset by an increase in the proportion of households headed by people in older age groups, among whom home ownership rates are typically much higher.

This sharp decline in home ownership rates among young and even middle-aged households seems especially surprising given that mortgage rates have been substantially lower since the 1991 census than they were in the preceding two decades, and that during this period governments have spent billions of dollars on first home owner grants and stamp duty concessions, ostensibly with the aim of boosting home ownership.

To some extent, the substantial decline in home ownership rates may reflect changing preferences as between home ownership and other personal goals among younger generations. But it is hard to believe (and there's no compelling evidence to suggest) that such changes explain much of the decline in home ownership among these age groups over the past two decades. It's much more likely that this decline is largely in response to deteriorating housing affordability – a concept which I want to explain in a little more depth momentarily – and more plausible that changing housing tenure preferences among younger adults are themselves a response to deteriorating housing affordability.

'Housing affordability' is conventionally measured by reference to the proportion of some measure of average income required to service the mortgage needed to purchase a median-priced dwelling assuming with a 20% deposit or downpayment, relative to the average value of that proportion over a suitably long period of time. By these measures, 'housing affordability' is a function of three variables - residential property prices, incomes and mortgage interest rates.

By such measures, housing is <u>not</u> currently as unaffordable as it has been on some previous occasions, such as immediately before the onset of the global financial crisis when the standard variable mortgage rate was close to 10%, or in the late 1980s or early 1990s when mortgage rates peaked at 17.5%.

However, this highlights the fact that the only reason that conventional measures of 'housing affordability' are not at all-time lows is that mortgage interest rates are at all-time lows, which in turn reflects the unusual combination of global and domestic factors which have shaped the Reserve Bank's monetary policy settings over the past few years.

It is also worth noting that conventional measures of 'housing affordability' do not take account of the impact of rising property prices on the difficulty of accumulating the 20% deposit which such measures assume home buyers will have.

Nor do they take account of the other costs associated with purchasing a median-priced dwelling - which in Sydney and Melbourne, at least, include considerably greater commuting times and expense than would have been the case when mortgage rates were at 17.5%.

The most important single factor detracting from 'housing affordability' over the past twenty years has been the almost relentless increase in residential property prices over this period - an increase which, in most of Australia's larger cities, has outpaced the rise in incomes, by a wider margin than in most other 'advanced' economies.

As you have already heard from the Reserve Bank this morning, the most important reasons for this rise in residential property prices were the substantial decline in interest rates and the increased availability of mortgage finance from the early 1990s onwards.

I would further argue, however, that the effects of lower interest rates and more widely available mortgage credit on residential property prices have been compounded by policies pursued by governments at all levels - Federal, State and local - over this period.

These policies have had the effect of simultaneously inflating the demand for housing and constraining the supply of it.

The introduction of large cash grants to first-time purchasers of established dwellings (by State Governments at the behest of the then Federal Government) in conjunction with the commencement of the GST in 2000, even though the GST did not apply to established dwellings - enabled such purchasers to pay more for the dwellings they bought than they would otherwise have done, thus contributing to the inflation of established dwelling prices. Fortunately, State Governments have now largely abandoned these grants.

The halving of the capital gains tax rate in 1999 made 'negative gearing' much more attractive to property investors than it had previously been (by turning into a vehicle for permanently reducing income tax, as opposed merely to deferring it as it had previously been), and thus had the effect of encouraging more investors into the property market. Since the proportion of taxpayers who have 'negatively geared' properties has increased significantly after 1999 - to the point where in the last few years borrowing for property purchases by investors has exceeded that by owner-occupiers - and since over 90% of geared investors purchase established properties, this has also added to the upward pressure on established property prices.

State Governments have compounded these pressures by offering increasingly generous stamp duty exemptions to first home buyers. Like cash grants to first home buyers, these have the effect of allowing home buyers to pay more for the properties they buy than they otherwise would, and thus of inflating property prices more generally. They are, in effect, grants to property vendors, not to home buyers.

A myriad of State and local government policies - in particular, planning laws, policies regarding the financing of suburban infrastructure, and urban transport policies - have had the effect of restricting increases in housing supply. The rate of growth in the 'underlying' demand for housing - driven largely by net immigration - has increased significantly since the turn of the century: but the rate of growth in housing supply, as measured by dwelling completions net of demolitions, has not, at least until the financial year just ended.

It's worth emphasizing the importance of the <u>interaction</u> of these policies affecting supply and demand on residential property prices.

Had housing supply not been constrained by State and local government policies, Federal and State policies which have had the effect of inflating the demand for housing would not have translated so readily into higher property prices.

In other words, far from promoting home ownership, the net effect of long-standing Federal, State and local government policies, insofar as they have affected home ownership, has been to reduce it, at least at the margin.

The combined effects of lower interest rates, more readily available mortgage finance, and Federal, State and local taxation and housing policies have been 'capitalized' into housing prices - to the particular benefit of those who already owned one or more properties before these trends became entrenched.

Given what we know about property ownership among different age groups - this amounts to a significant redistribution of wealth from younger households to older ones. And given what we know about property ownership among different income groups, it amounts to a significant redistribution of wealth from poorer to richer households.

Whether one thinks this is a Bad Thing or not is partly a matter for political judgement - and that's your job, not mine.

I acknowledge that a large number of Australians believe that they have benefited from the increase in residential property prices which has occurred over the past decade. Indeed, the fact that at any given point in time, there are over 8 million Australians who own one or more residential properties, whereas in any given year there will be somewhere between 50,000 and 150,000 Australians who become first home buyers, probably explains why governments of both political persuasions have remained so committed to policies which benefit those who already own properties at the expense of those who don't.

However I think it is increasingly debatable whether continued increases in residential property prices are a Good Thing for the Australian economy. That's because, since the onset of the financial crisis, Australian households have become much less willing to borrow against increases in the value of the properties which they own in order to fund other types of spending. Indeed it would seem that the only thing for which Australians remain keen to take on more debt is to acquire investment properties. There is thus much less of a positive 'wealth effect' from rising house prices to economic activity than there used to be.

I also believe that further significant increases in residential property prices from present levels - especially to the extent that they are driven or accompanied by further increases in the level of household debt - pose an increased risk to the stability of the Australian economy. Ironically that's partly because we are now belatedly beginning to see significant increases in the supply of housing (notwithstanding the absence of significant changes to State and local government policies which have hitherto had the effects of constraining housing supply) - the activities of foreign investors are important here. One of the important lessons from the experience of countries such as the US, Ireland and Spain is that the combination of rapid increases in both housing prices and housing supply can turn out to be lethal, especially once interest rates begin rising after an extended period of being unusually low.

Finally, I believe - although I readily acknowledge this is a belief on my part, rather than something I can prove empirically - that further significant increases in housing prices from current levels are likely to cause social harm.

You've already heard from the Reserve Bank today why home ownership has long been considered a Good Thing by Australians - because of its contribution to reducing poverty in old age, because of its contribution to providing a stable environment for raising children, because of the contribution it makes to fostering community engagement, and because of the security it often provides for the financing of small businesses.

Those things, to which a large majority of Australians have traditionally aspired, are likely to become less accessible to an increasing proportion of Australians if residential property prices continue to increase and home ownership rates continue to decline.

Thank you once again for the opportunity to share these thoughts with you, and I would be happy to answer any questions that you may have.