

@

**FIRST HOME OWNER GRANTS:
WHAT ARE THE LESSONS FOR
POLICY MAKERS?**

**A Submission to the Productivity
Commission Inquiry into First Home
Ownership**

October 2003

**Gavin A. Wood,
Murdoch Business School,
Murdoch University,
WA**

1 Introduction

In this submission I address some key aspects of the Productivity Commission's terms of reference. In particular;

- What are the impediments to first homeownership?
- What mechanisms will improve the ability of low-income households to benefit from owner-occupied housing?

In recent years the findings from econometric models of tenure choice suggest that binding borrowing constraints drives access to homeownership. That is the inability to meet the deposit requirements of house purchase and/or the mortgage repayment conditions is critical in explaining tenure outcomes. Though much of this research is United States based, it has received confirmation in Australia through the work of Bourassa (1995 and 1996).

More recently Wood, Watson and Flatau (2003)¹ have used a Microsimulation Model of the Australian Housing Market (AHURI-3M) to analyse the tenure choices of 9276 Australian income units². We also find that borrowing constraints play a particularly influential role in explaining who succeeds in climbing the housing ladder into homeownership. A particularly important finding is that among the 4,203 rental tenants in our sample, a majority of 2939 tenants would be better off on an annual economic cost basis if they could become homeowners, but borrowing constraints impede access to these benefits. In other words there is a considerable latent demand for homeownership in Australia, and failure to satisfy this demand under current institutional (e.g. tax) arrangements is inefficient. Binding deposit and repayment constraints impact on 60% (1763) of these tenants while 30% (884) are subject to binding deposit constraints only. Deposit constraints are then the most important of the borrowing constraints confronting first homebuyers.

In the next section we assess the efficacy and equity of Commonwealth First Home Owner Grants (FHOG) in meeting this latent demand for homeownership. This is followed in a concluding section by a proposal that would introduce assistance that is targeted on low-income households, and is designed to avoid blunting work incentives.

2. First Home Owner Grants: Housing Market Impacts

First Home Owner Grants (FHOG) can change the tenure decisions of potential first homebuyers in two ways:

¹ The findings summarised in this research letter represent an update of those reported in Wood et al (2003). The model was designed with the assistance of grant 80088 from the Australian Housing and Urban Research Institute.

² The analysis reported below uses income units rather than households as the measurement unit.

- Their amortised value alters the annual economic cost of housing in favour of homeownership rather than renting. This raises the long run equilibrium rate of homeownership, which is the share of the current income unit population that will choose homeownership at some point in their housing careers because it offers cheaper housing.
- Their impact can be to relax binding borrowing constraints for those income units that already find housing cheaper as homeowners. These income units would if rational become homeowners at a later date in their housing careers, but first homeowner grants accelerate the transition into homeownership. This has a short run impact on the rate of homeownership, but has no impact on the long run equilibrium rate of homeownership.

Microsimulations using AHURI-3M find that the second of these two impacts is much more important. Thus FHOG accelerate purchase intentions rather than changing the tenure choice decisions that income units would make on relative price grounds. Advancing the transition of those renters subject to binding borrowing constraints does provide efficiency benefits, but will do little to raise the rate of homeownership in the long run.

AHURI-3M has also been used to identify the segments of rental tenures that predicted FHOG recipients vacate. This is a potentially important issue since properties vacated by FHOG recipients are in principle an addition to the supply of public and private rental housing. Public housing is rationed at subsidized rents and allocated on the basis of housing need; if the private rental property that is vacated also tends to come from low rent segments, a policy instrument such as FHOG can be said to increase the supply of rental housing affordable to low income groups ('trickle-down effects'). Our findings indicate that trickle-down effects are muted because 41% of FHOG recipients are predicted to come from shared dwelling arrangements, the majority of which are young single persons living rent-free with their parents. Furthermore, only 3.7% of FHOG recipients vacate public housing, which is disproportionately low (public tenancies house 11.5% of all tenant income units). On the other hand, private renters forecast to become homeowners as a result of FHOG, typically live in the two lowest rent quartile segments of the private rental stock. There is then mixed evidence with respect to trickle-down effects.

Tables 1, 2 and 3 below compare the demographic and socio-economic characteristics of those tenants the microsimulation model predicts will take-up FHOG with two other tenant groups; those eligible tenants that are predicted by the model to continue renting, and those tenants who are ineligible because they have been homeowners earlier in their housing careers.

Table 1 indicates that young singles dominate the take-up of FHOG. They are typically 30-34 years old, and 73% are not married. Their total income, particularly wage and salary income, is high relative to other tenants. Table 3 shows annual average income of recipients is \$14,411 (at 1996-'97 prices) higher than tenants who are also eligible for FHOG but do not take-up the offer. Only 8.6% of FHOG recipients benefited from Commonwealth rent assistance as tenants, and an even lower 4% come from public housing (see Table 2). In fact the distribution of grants amongst potential first homebuyers is highly inequitable. The

poorest 40% of potential first homebuyers is forecast to account for only 9% of grants, while the richest 40% account for 77% of grants.

Eligible tenants who do not take-up FHOG are much more likely to be receiving Commonwealth rent assistance or reside in public housing. They are slightly younger than recipients, and are much more likely to have dependent children. In addition to lower incomes they have lower rates of labour force participation and are more likely to be unemployed. Their representation amongst those with qualifications is lower than that of FHOG recipients, and 65% have no qualifications at all.

The ineligible group of tenants are much older and they are typically married, divorced or widowed. Their income levels are similar to those of eligible tenants, but government cash transfers are a much more important source, with nearly three-quarters of this group receiving Commonwealth rent assistance. Labour force participation rates are very low, and a majority (65.5%) have no qualifications and so labour market prospects are poor.

Table 1. Demographic Characteristics - \$14,000 FHOG

	<i>Total Sample</i>	<i>FHOG Recipients</i>	<i>Eligible Income Units who Remain Rental Tenants</i>	<i>Ineligible Income Units</i>
Median Age*	40-44	30-34	25-29	55-60
One or more persons aged over 65.	17.9%	2.0%	6.5%	38.7%
Dependent Children	29.0%	8.2%	21.1%	22.5%
Sole Person	46.9%	82.3%	82.7%	59.9%
Marital Status*				
Married/De facto	48.3%	18.2%	18.0%	41.7%
Divorced, Widowed or Separated*	20.8%	8.9%	16.2%	39.0%
Never Married	30.9%	72.9%	65.7%	19.3%
Sample Size	9276	643	2327	2013

*Income unit reference persons.

Table 2. The Housing and Wealth of Tenants - \$14000 FHOG

	<i>Total Sample</i>	<i>FHOG Recipients</i>	<i>Eligible Units Remain Tenants</i>	<i>Income who Rental</i>	<i>Ineligible Income Units</i>
Current Weekly Rent (Tenants)	A\$75	A\$69	A\$65	A\$40	
Rent Assistance	9.8%	8.6%	34.7%	73.9%	
Optimal Housing Demand	A\$137,381	A\$89,721	A\$88,902	A\$109,842	
Public Housing	5.2%	3.7%	14.6%	5.9%	
Private Rental Tenancy	39.5%	51.0%	38.1%	24.9%	
Metropolitan Residence	60.7%	45.7%	66.6%	57.3%	
Liquid Assets	A\$36,405	A\$2,802	A\$2,474	A\$12,310	
Sample Size	9276	643	2327	2013	

Table 3. Income and Employment of Tenants - \$14,000 FHOG

	<i>Total Sample</i>	<i>FHOG Recipients</i>	<i>Eligible Units who Remain Rental Tenants</i>	<i>Income Ineligible Units</i>	<i>Income</i>
Annual Income ¹	A\$33,020	A\$31,736	A\$17,328	A\$19,324	
Wages & Salaries ²	A\$34,309	A\$27,540	A\$16,906	A\$20,755	
Annual Income from Investments ³	A\$1,543	A\$164	A\$63	A\$603	
Government Transfers ³	A\$3,797	A\$1,036	A\$4,049	A\$7,249	
Labour Force Status ⁴					
Full-time	55.9%	79.2%	48.5%	28.1%	
Part-time	7.3%	5.8%	11.5%	6.8%	
Not in Labour Force	30.1%	7.3%	26.1%	58.7%	
Unemployed	6.6%	7.8%	13.8%	6.5%	
Education ⁴					
Post-Graduate	4.2%	2.7%	2.3%	2.2%	
Under-Graduate	17.7%	19.4%	14.6%	11.5%	
Vocational	23.8%	26.6%	17.3%	20.6%	
No Qualifications	54.2%	51.3%	65.4%	65.5%	
Occupation ⁴					
Managers and Administrators	9.9%	3.5%	2.9%	9.0%	
Professionals	29.3%	27.5%	22.7%	28.1%	
Tradespersons	18.7%	21.4%	16.8%	15.5%	
Clerical	21.9%	29.3%	33.9%	21.1%	
Production and Transport	10.9%	11.0%	10.5%	11.7%	
Labourers	9.0%	7.3%	13.2%	14.4%	
Sample Size	9276	643	2327	2013	

1. Income unit mean total annual income from all sources.

2. Mean annual income of employed reference persons.

3. Income unit mean income from source.

4. Income unit reference person

5. Reference person's occupation in current job. Excludes the unemployed and those persons not in the labour force.

3 Policy Reform: The Home Credit Fund³

FHOG was introduced to offset the direct impact of a new consumption tax (the GST) on the prices of new houses and the indirect impact on the prices of established houses. It was not introduced as a measure designed to improve the ability of low-income households to benefit from owner-occupied housing. However, as the only direct Commonwealth ownership subsidy⁴ the specific impacts of FHOG on long run rates of homeownership and its distributional impacts should be considered in any inquiry into the affordability and availability of housing for first homebuyers. While the \$14000 FHOG succeeded in sustaining activity in the house construction industry, the evidence we have presented suggest that it is ineffectual as far as the homeownership prospects of low-income households is concerned. This is particularly evident for income units in public housing or income units receiving Commonwealth rent assistance.

A Home Credit Fund (HCF) programme is an alternative that I believe is worthy of serious consideration. The HCF permits economically inactive transfer payment recipients in rental tenures to receive a share in the public expenditure savings that accrue on transition into part-time or full-time employment. Their share is 'credited' in a trust fund called the Home Credit Fund that can be subsequently drawn down to meet deposit requirements or mortgage repayments on home purchase. Access to the fund is conditional on sustaining a continuous qualifying period of employment. The HCF addresses two policy questions:

- How can we offer homeownership assistance that is targeted on low-income households?
- How can we achieve this in ways that avoid blunting work incentives?

HCF strives to achieve targeting objectives by making receipt of a Federal pension, benefit or allowance a 'passport' to HCF eligibility. It will do so imperfectly because there will be low wage earners in rental housing who are ineligible for HCF assistance⁵. However, if the FHOG programme is retained this low income group will still have access to a direct subsidy programme. The 'passport' requirement of the proposed HCF programme has the advantage of combining promotion of low-income homeownership with potentially powerful work incentives. By sharing the public expenditure savings that accrue as a result of transitions into employment, HCF actually sharpens work incentives.

This is an important aspect of the HCF proposal as it highlights an alternative policy approach to addressing poverty and unemployment trap issues. As Beer (2003) shows even radical changes to the Australian tax and benefit system can have limited effects on effective marginal tax rates. Rather than seeking to lower effective marginal tax rates by complex changes to the way in which taxes and transfer payments interact, proposals

³ This section has benefited from correspondence with Dr Owen Donald, Director of Housing, State Government of Victoria.

⁴ There are indirect subsidies to homeowners delivered via the tax system and various direct forms of assistance offered by state governments.

⁵ As Wood, Forbes and Gibb (2003) show this is also an issue with Commonwealth rent assistance, which is conditional on receipt of a benefit, pension or allowance.

such as HCF offer an incentive that is conditional on employment and which promotes other policy goals, in this case housing policy goals. It also has the virtue of economising on public spending outlays if HCF reduces unemployment and hence the demands on income maintenance programs such as Newstart allowance. The evidence offered in Flatau et al (2003) indicates that there are important relationships between housing tenure and unemployment in Australia. Of particular relevance to proposed low income homeownership programmes such as HCF is the finding that home purchasers are much less likely to become unemployed, and if they do become unemployed, the duration of unemployment spells is relatively short. This suggests that those becoming home purchasers as result of transitions into employment (and HCF assistance) will have a more permanent attachment to the employed labour force (then would otherwise be the case).

There are of course policy design issues that a proposed HCF needs to address:

- Moral Hazard problems might arise if there is ‘gaming’ of the eligibility rules such that some people deliberately make labour market decisions that ensure eligibility for HCF assistance.
- Adverse selection problems arise in the sense that HCF assistance is targeted on those who could be least able to sustain the longer run financial responsibilities of homeownership.
- What share in transfer payment ‘savings’ and duration of entitlement will offer meaningful assistance to the target group?

Careful design of eligibility and entitlement rules can address these issues. The requirement that households complete a qualifying period of continuous employment before eligibility for HCF assistance is a response to adverse selection issues. The Housing Lifeline Proposal (Menzies Research Centre, 2003) is a potentially valuable policy initiative that is complementary to low-income homeownership initiatives such as HCF, since it would also help address the adverse selection issue. Finally, judicious use of pilot programmes such as those recently initiated by the Department of Housing and Urban Development in the United States to evaluate homeownership vouchers can help guide policy makers in relation to these design issues.

References

Beer, G. (2003) Work Incentives under a New Tax System: The Distribution of Effective Marginal Tax Rates in 2002, *The Economic Record*, Vol 79, Special Issue pp 514 – 525.

Bourassa, S. C. (1995) A Model of Housing Tenure Choice in Australia, *Journal of Urban Economics*, Vol. 37, 161-175.

Bourassa, S.C. (1996) Measuring the Affordability of Home Ownership, *Urban Studies*, Vol.33, No.10: pp.1867-1877.

Flatau, P., Forbes, M., Hendershott, P.H. and Wood, G.A. (2003) Homeownership and Unemployment: The Roles of Leverage and Public Housing, National Bureau of Economic Research, Working Paper 10021, Cambridge, MA (USA).
<http://www/nber.org/papers/w10021>

Gans, J. and King, S. (2003) Policy Options for Housing for Low Income Households. The Menzies Research Centre, Vol. 2, 1-85.

Wood, G, Forbes, M and Gibb, K (forthcoming, 2003) Are Personal Subsidies Effective in Reversing Housing Affordability Problems? An Empirical Evaluation of Australia's Rent Assistance Programme. University of Glasgow, Department of Urban Studies, Working Paper Series.

Wood, G., Watson, R. and Flatau, P. (2003) 'A Microsimulation Model of the Australian Housing Market with Applications to Commonwealth and State Policy Initiatives', Final Report, Australian Housing and Urban Research Institute, Western Australia.