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# ‘Explaining the housing market puzzle’

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- In August 2003, the Treasurer asked the Productivity Commission to conduct a public inquiry into the affordability of housing for first home buyers.
- The backdrop:
  - since 1996, house prices had more than doubled; 80% up in real terms (half of which in previous 3 years)
  - longest and cumulatively largest price surge on record
  - median prices went from 6 to 9 times average annual earnings
  - halving in share of new housing loan approvals going to first home buyers (14 to 7%)
  - evidence of rising housing ‘stress’ for low income people (renters)
- The debate that ensued from these events was muddled and politicised
  - welcoming of (apparent) gains in wealth to existing home owners; disapproval of the (consequent) difficulty for those seeking to own a home.
  - opposing views on *causes*:
    - ... a demand-induced bubble (seen as likely to burst, at some risk to economic growth)
    - ... a consequence of (State) government supply-side policies: restricted supply of land, excessive taxes/charges, and burdensome regulatory requirements.
- A basis for multiple accusations and point-scoring, and for a confused (and alarmed) electorate.

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- In short, a suitable task for the Productivity Commission! (Independence, open and consultative processes, and recommendations based on a community-wide perspective)
  - Also a task for *economists*.
    - A complicated market (or set of inter-dependent markets). For example, a dwelling is both a ‘home’ and an investment; predominantly debt-financed; each dwelling unique (style, size, location, siting); supply and demand both slow to respond; ‘overshooting’ common (booms and busts).
    - Complexity adds to confusion. Nicely illustrated by a recent industry comment, reported in the *Australian Financial Review*, that a prospective interest rate rise “will not be good for sellers, and it will not be good for buyers”(!)
  - What did we find?
    - Complex, but laws of supply and demand do apply! Both sides played a role.
    - But our bottom line was that the *dominant* cause of the price growth observed from the mid-1990s was a general surge in demand, driven by falling interest rates and rising incomes, to which supply was *inherently* incapable of responding, at least in the short term.
  - The findings have been accepted by most economists (eg see Saunders article). But our emphasis on the demand side was not uncontested; so a question as to how well our assessment stands up 2 years on.
  - A key element in the demand story was the halving of interest rates through the 1990s. (Even with more recent increases, they are still less than half what they were in 1990 – ie 16.5%!)
    - this effectively doubled the size of home loan that the average household could afford and, over time, led to significant ‘trade-up’ demand from existing home owners (reinforced by strong job and income growth)
    - it also encouraged greater *investment* in rental properties (reinforced by a ‘supportive’ tax environment, especially after the 1999 capital gains tax changes)
  - This explains why price-to-income ratios are not a good indicator of affordability trends at such times. Falling loan service costs meant that overall affordability actually *improved* through the 1990s, despite the rise in house prices.
  - However affordability fell sharply after 2000. And prices reached levels beyond what could be explained in terms of purchasing power and demographics.

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- Evidence of price ‘overshooting’, plus scope for the housing supply to respond over time, led us to predict (tentatively) an improvement in affordability through a market correction.
  - Has it happened?
    - Short answer is that it *has*, but not yet by enough to restore previous affordability levels.
    - Sydney prices, which took off first and soared highest, have predictably also dropped off most (10% nominal decline, 15% real). Prices have only fallen in particular market segments in other cities (eg high rise units in Melbourne). On average prices have continued to rise slightly, though staying flat in real terms.
    - Perth is the exception, with prices actually accelerating in recent years, reflecting again particularly strong demand pressures (the mining boom) in that State.
  - Affordability indexes have consequently improved, despite rate rises, in all capital cities except Perth – and are now better than in the late 1980’s (when rates were very high).
    - First home buyers are back in the market in larger numbers than for most of the 90s.
    - That said, loan repayments are still historically high as a share of family income. More first home buyers may be realising their dream, but under greater financial duress.
  - That we are seeing the effects of an unwinding of demand-induced excess, rather than supply catch-up, is supported by data showing housing commencements to have *declined* in this period in the Eastern States.
  - Recently, market watchers have been reporting signs of a pick-up in some segments/markets. Further (real) price falls are thus not assured, though recent (and prospective?) interest rate adjustments may be influential.
  - So, on the assumption that further improvements in affordability would be desirable, what can or should governments do?
  - In general terms, as the Commission argued in 2004, governments need to address any regulatory or other measures which unduly inflate demand or constrain supply over time.
  - Note the word “unduly”. Housing demand from the 90s was spurred by historically low interest rates and high incomes – no-one would want to see these reversed!

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- The Commission identified more suitable candidates for demand-side action among income tax provisions and subsidies that favour housing. (Negative gearing is usually seen as the main culprit. But we saw it as less problematic than the concessional arrangements for capital gains taxation that were introduced in 1999 and appeared to be having a pro-cyclical effect on investment demand.) Our call for a broader, detailed review of such provisions, which apply more widely than housing, was not accepted at the time. Since then, income tax rates have been cut. This should reduce the value of the concessional provisions and may (optimistically!) alter the politics of a review.
  - What could or should be done on the *supply* side?
    - (Unexpected) surges in housing demand will push up prices in the short run, but the extent to which higher prices persist, obviously depends on how well the supply of housing can respond over time.
    - There are two sources of new housing: greenfield (fringe) developments and redevelopments to achieve higher density within established areas.
    - Expansion of the urban fringe has been restricted in most cities, for the stated purposes of economising on infrastructure and addressing environmental concerns. How restricted is disputed. More so at that time in Sydney than Melbourne (greater topographical constraints though).
      - ... There is a good case for allowing market forces more sway in how cities develop, provided that infrastructure and other attributable costs of new developments are reflected in house prices or charges.
    - But even *unlimited* scope to develop the fringe can have only a limited impact on average house prices in more established areas. Location matters greatly in housing markets, as every real estate agent knows. It has been the established areas – with their inherent amenity and transport advantages – that have attracted much of the demand and seen the largest price increases.
      - ... Remember, much of the increased demand through the 90's came from people who already *had* a home, they wanted to use their rising purchasing power to trade up or upgrade. Building new dwellings on the urban fringe could only ever satisfy a *fraction* of this demand. (Sales of new houses rarely exceed 2 per cent of the housing stock, compared to annual turnover of 6-8 per cent.)
      - ... Even now, with new housing construction depressed, industry sources are saying that demand is still relatively strong in established areas.
    - This is not to say that urban consolidation policies have had no effect on land prices. After all, such policies are designed to constrain supply at the fringe.

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- If they succeed, this must push up prices unless people are indifferent as to where they live and the supply of dwellings can be as readily expanded (and at comparable cost) in established areas. The evidence tells us that this is not the case.
- This partly reflects community resistance to higher density re-developments. While derided as NIMBYism, it is also an expression of preferences and involves (defacto) property rights. Democracies can't ignore this.
  - That said, greater supply-side responsiveness is both feasible and desirable. The Commission noted a number of deficiencies and unwarranted delays in planning approval processes and land release strategies.
  - Another potential source of undue housing cost relates to excessive or inappropriate regulatory standards. The Productivity Commission, and the Regulation Taskforce that I chaired, have both drawn attention recently to the lack of adequate cost-benefit analysis in socially or environmentally motivated building regulations and standards.
    - ... eg the recent elevation of home energy efficiency standards to 5 stars, could cost 3 times the \$3000 initially envisaged and needs to be reassessed.
    - ... Heritage regulation plays an important role, but it is often over-zealous, and poorly justified, imposing substantial costs on those affected and preventing some socially valuable re-developments.
  - Also, while it is important that new home buyers bear costs for which they are responsible, some infrastructure costs seem excessive, particularly for social amenities or facilities for the wider community. Note that up front charging for infrastructure is not the real problem. It does add to prices, but does not necessarily reduce *affordability* over time (lower periodic charges).
  - [A caveat here — if charges are excessive, they effectively amount to a *tax*. As such, like stamp duties and other taxes, they will be partly borne by the land owner as well as the home buyer.]
- Finally, in this context it's worth remembering that people's tastes and expectations have changed greatly as we have become a more affluent society. A small fibro bungalow on an unmade road, and without paving/guttering or sewerage — my parents' first home — would not be contemplated by many young couples today, even if it was available. By the same token, my parents would not have been attracted to the little inner city terrace with a tiny backyard that my daughter and her fiancé have just bought!
  - Like the old ad about oil, houses ain't houses. Comparisons are hard to make. We need to be wary of simplistic nostrums in such complex markets.