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Housing Affordability in Australia and the UK: Common problems and Common Solutions

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HOUSING AFFORDABILITY IN AUSTRALIA AND THE UK: COMMON PROBLEMS AND COMMON SOLUTIONS

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HOUSING AFFORDABILITY IN AUSTRALIA AND THE UK: COMMON PROBLEMS AND COMMON SOLUTIONS

Henry Halloran was born in 1869 and it is in the late-Victorian era that I want to start. According to the Australian Dictionary of Biography, Mr Halloran was a member of the Royal Australian Historical Society. He was also a Fellow of the Royal Society of Arts in London and so we have that in common. But before the history, I want to set out briefly some key messages that I will try to justify this evening.

1. **Housing should be seen in a long-run context, since policy and outcomes cannot be changed quickly. But for most households, housing conditions have improved enormously over the last 50-100 years. Housing problems are about tails in the distribution. Nevertheless, many improvements have not come about through explicit housing policies. Housing policy is a poor relation to wider fiscal and monetary policy and this contributes to high housing market volatility.**
2. **Declining home-ownership – temporary or permanent: Too much credit or too little? Our research indicates that, in addition to demographics, the propensity to become a home owner depends on affordability, the income distribution, credit availability and competition from investors. On this basis, some (but not all) of the factors causing declining home ownership may be temporary. But, the housing problems of low-income households are not cyclical, but structural.**
3. ***General* increases in housing supply have only a limited effect on affordability unless they are large and sustained and are accompanied by changes in fiscal policy. These are not alternatives.**
4. ***General market* increases in housing supply have only a limited trickle-down effect to affordable housing for low income groups. Therefore, targeted approaches are required.**
5. **Funding for low-income housing will not primarily come from government and, therefore, there is a need for innovative funding methods.**

Housing in a Long-Run Context

1. **Housing should be seen in a long-run context, since policy and outcomes cannot be changed quickly. But for most households, housing conditions have improved enormously over the last 50-100 years. Housing problems are about tails in the distribution. Nevertheless, many improvements have not come about through explicit housing policies. Housing policy is a poor relation to wider fiscal and monetary policy and this contributes to high housing market volatility.**

It is helpful to begin with historical comparisons, because affordability problems are not new and have long existed in both Australia and the UK, at least for some sections of the communities. For example, Judy Yates (2013) recently considered post-2007 affordable housing reforms against the background of social housing over the previous fifty years, but I want to go back even further than this. One reason for the comparison between the two countries is that trends in housing markets depend at least partly on the structure of institutions; those countries that developed from a similar institutional structure, in terms of laws and social norms, are at least partly likely to experience common problems and outcomes in housing and other markets. For example early 20th century planning legislation in Australia was heavily influenced by the British model, even though the frameworks subsequently diverged, particularly after the UK 1947 Town and Country Planning Act and the differences are now reflected in approaches to affordable housing provision. Comparisons between the UK and Australia are certainly not unprecedented; for example, in an AHURI report back in 2004, Mike Berry and his team compared methods of financing affordable housing in the two countries – an issue which still remains relevant[1]. Also Patricia Austin, Nicole Gurran and Christine Whitehead compared in 2014 planning and affordable housing regimes in Australia, New Zealand and England[2]. By contrast, Germany developed from a very different institutional structure and has, as a result, experienced very different housing outcomes. But we could not easily import the German housing system into the UK or Australia, although it is sometimes said we should. For similar reasons, history, through the structure of institutions, imposes constraints on current policy choices; housing policy rarely changes radically, because even the most reformist administrations are heavily constrained by the actions of previous governments. At one level, this arises

[1] See Mike Berry, Christine Whitehead, Peter Williams and Judith Yates (2004).
[2] See also Gurran and Whitehead (2011).

simply because of the physical structure of cities; urban planning decisions today are constrained by the building decisions of decades if not centuries ago. But, the constraints from history are wider than this.

The table below compares death rates in selected areas of the British Empire in the late 19th century. What stands out is that both NSW and Victoria were relatively healthy places to live, compared with the major cities of the UK and much of the Empire and housing differences were part of the explanation. Of course, it could also be the case that the young and healthy were attracted to Australia, the weather was better, and Australia never experienced the extremes of income inequality found in the UK. Glasgow, by contrast, was one of the least healthy parts of the Empire, summarised by the following quotation. For modern comparison the crude death rate in London was 5.6 per thousand population in 2014 (the lowest region in the country) and 10.5 in Glasgow.

Death Rates in the Empire, (Deaths per 1000 living residents)

Period	England & Wales	London	Glasgow	New South Wales	Victoria	Ceylon	Jamaica
1881	18.9	21.3	25.3	15.1	14.2	27.2	26.0
1905	15.2	15.7	19.8	10.1	12.1	27.7	21.9
Source. 1905 Registrar General's Report, for England & Wales, Table 44. Registrar General's Report for Scotland, 1881 and 1905							

' The tenements in which I have visited are occupied from the cellars to the allies, and almost altogether kept for lodging houses, many of them being more fit for pig-styes than dwellings for human beings; and in not a few the donkeys and pigs rest at night in the same apartment with the family. The entrance to these abodes is generally through a close, not unfrequently some inches deep with water, or mud, or the fluid part of every kind of filth, carelessly thrown down, …'

Report of the Glasgow Fourth District Surgeon, Perry (1844)

The recognition that there was a strong relationship between poor housing and disease was important, typified by the discovery of the causes of Cholera in water supplies in the mid-19th century. In fact most of the early UK legislation surrounding housing was related to sanitation. I would not, of course, want to suggest that all was well with Australian housing conditions. Some of the most graphic descriptions of slum conditions in Melbourne appear in Fergus Hume's 1886 classic thriller, *The Mystery of a Hansom Cab*, but, as a generalisation, conditions were better than in the worst areas of Glasgow or London.

Therefore, a first theme that I want to stress tonight is that housing conditions have improved enormously for the vast majority of households over the last 100 years, but we tend to forget this because of the regular housing crises that have hit both countries. However, by and large, the changes to housing have not (with important exceptions) come about because of housing policy; they have been the by-product of wider movements or changes to the nature of the economy. In this case the gains came from scientific discovery backed up with associated legislation. Other major changes have been associated with technological advances, notably rail and road infrastructure; the development of modernist urban design had a huge impact; the liberalisation of financial systems in the 1980s - in the case of Australia initially through The Campbell Inquiry – resulted from the shift towards free market policies – but had a major effect on housing through reforms to mortgage markets. There are strong limitations on what housing policy can achieve in practice. Some housing policies in the UK at the moment look distinctly odd, but they are second-best attempts to overcome the constraints imposed by macro policy. In the words of Nicole Gurran and Peter Phibbs, politicians concerned with housing policy often "look busy" without adopting policy measures that will disturb the status quo. This is partly because action is constrained by special interest groups, but also because housing is the poor relation to wider macroeconomic policies. Tony Dalton has also pointed to the subordination of social policies to larger economic considerations in a comparison of Australia and Canada.

2. Declining home-ownership – temporary or permanent: Too much credit or too little? Our research indicates that, in addition to demographics, the propensity to become a home owner depends on affordability, the income distribution, credit availability and competition from investors. On this basis, some (but not all) of the factors causing declining home ownership may be temporary. But, the housing problems of low-income households are not cyclical, but structural.

To address the second set of issues, we move away from history and turn to the present; it is helpful to remind you of the recent changes to owner-occupation rates in the two countries – ownership rates have fallen in both, but more sharply in England. Ownership peaked at approximately 71% in 2003, but now stands at 63% - this is a very large change over a fairly short period; in Australia after relative stability at around 70% for several decades[3], the rate stood at 67% in the 2011 census.

There seems to be a general view that these falls are permanent, not cyclical, and will continue, led by declining rates among young, first-time buyers. Governments have been keen to provide support in both countries. Owner-occupation has long been considered to be the most desirable tenure – indeed it is seen almost as the social norm or even as a right; as the English Housing Minister recently said to the House of Lords Economic Affairs Select Committee:

"Ultimately we are public servants and serve the people who elect us, and 86% of them want to own their own home. It is entirely logical that we are very clear that our focus is on increasingly housing supply and moving home ownership back in an upwards direction. " (page 27, transcript of evidence by Brandon Lewis MP to the House of Lords Economic Affairs Committee, 22nd March 2016).

Consequently, the attempt to increase home ownership has dominated housing policy over the last year or more. But we need to look at this a little more carefully. There are dangers in putting too much emphasis on expanding ownership through policy in both countries.

[3] although declining somewhat between the early 1980s and mid-1990s, concentrated on the younger age groups, Yates (2002(, Dalton (2009).

Tentatively, there are reasons to believe that not all of the fall in ownership is permanent, whereas the housing problems of low-income groups are more deep-rooted. Nevertheless, there clearly are structural factors that have affected ownership. As Gavin Wood and Rachel Ong have pointed out these include globalisation, more flexible labour markets, the build-up of debt, which adds to risk and it appears to be the case that churn between ownership and renting is more common in Australia than the UK for those on the fringes of ownership. So I need to be a little circumspect in my conclusions here.

But, we tend to forget that, in contrast to Australia, high levels of ownership in England are fairly recent; in 1971 only 50% of households were owners (compared with around 70% in Australia) and the rapid rise came about because of forms of subsidy; mortgage interest tax relief and Right to Buy sales – the sale of local authority dwellings to sitting tenants since 1980 - being prominent. Home ownership is a market good and an investment and, hence, can go up as well as down. From an economics perspective, there is no necessary reason to be concerned about the fall in home ownership. Although housing is a merit good - it is judged by society that everyone should have access to decent housing on the basis of need rather than ability to pay – this says nothing about tenure or the preference for ownership over renting. Any advantages of ownership (for housing of the same quality) arise, first, from perceived externalities; for example are owners better citizens or do they have higher productivity, health or education outcomes? But this is not straightforward to demonstrate in advanced societies. And, second, home ownership contributes to inequalities in society. The capital gains experienced by home owners clearly give a major advantage over renters and have intergenerational consequences as well as implications for asset-based welfare programmes.

Box 1

There are significant issues for low-income households arising from an over-concentration on restoring home ownership, particularly in an environment where there are stringent controls on overall public expenditure. Increasing home ownership is not a free good. Policy is fighting against strong market forces and attempts to overcome those forces can be at the expense of affordable housing for those towards the bottom of the income distribution.

To give two examples of current English government policy, which disadvantage low income housing:

First, a policy objective is to increase the number of first-time buyers by 2 million over the five year lifetime of the current Parliament – this is approximately double the number achieved between 2011 and 2015. It is fairly clear that the aspiration will not be met without policy intervention. In recent years, policy has concentrated on ways to mitigate the severe deposit requirements faced by first-time buyers, notably through Help to Buy and Shared Ownership schemes – and I will come back to these. This is a perfectly reasonable response, but these schemes have, this year, been enhanced by a Starter Homes initiative, where 200,000 new homes over the life time of the Parliament can be sold to new buyers under the age of 40 at a 20% discount of the market price. However, as an offset, builders are released from their obligations to provide new affordable social housing under Section 106 agreements.

Second, housing associations are being required to reduce their rents by 1% per annum for the next four years. This is an attempt to cut the rapidly expanding Housing Benefits bill (the equivalent to Commonwealth Rent Assistance), but, by cutting their rental streams, it reduces the ability of housing associations to borrow for social rental housing. Although housing associations will not necessarily reduce the total number of new homes built, they are likely to increase the share, which are built for sale rather than low-cost rentals.

Lord Kerslake – a strong critic of the 2016 Housing and Planning Bill, which includes the first of these measures, and a former Permanent Secretary at the Department of Communities and Local Government (DCLG) has remarked:

> *It is simply not possible to deliver the new housing the country needs without building more houses of all types and tenures, including social housing.*

Our research[4] indicates that, in addition to demographics, a set of key (not necessarily independent) factors influence the likelihood that an individual will be an owner; these include:

- Affordability
- The availability of mortgage credit (notably deposit requirements)
- The income distribution
- Competition from the investment market

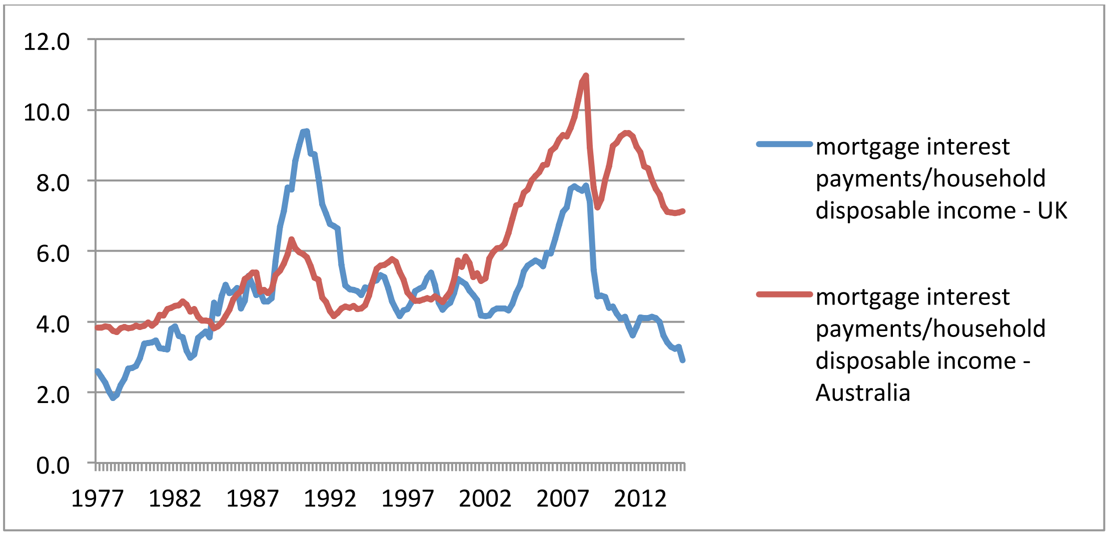
[4] See, for example, Meen (2011).

Some of these are cyclical, or temporary, and some more structural or possibly permanent. We take each in turn.

So far I have been rather loose in defining affordability and affordable housing; they are not the same and different definitions have different policy implications. **Affordability** is a concept which typically applies to the housing market as a whole; the most common measure is the ratio of house prices to incomes, although it can be very misleading, particularly at times of low interest rates. I have long argued that we should pay only limited attention to price-to-income ratios and I do not want to prolong their usage here.

A slightly different measure for owners is the ratio of mortgage interest payments to income, which captures changes in interest rates as well. Since 1977, mortgage interest payments in Australia have averaged approximately 6% of household disposable income and slightly less in the UK, although it should be borne in mind that these are averages and the ratios would be much higher for first time buyers or those at early stages of their housing careers[5]. But since the Global Financial Crisis, payments in the UK have been noticeably lower than in Australia – this primarily reflects lower mortgage interest rates, but also the fall in the mortgage stock that occurred in the UK, but not in Australia. On this measure, affordability in Australia has noticeably worsened in recent years, but it is hard to see that worsening affordability would account for the fall in the home ownership rate in the UK since 2003. Furthermore, any long-run trend in this measure of affordability is limited, although highly volatile. Therefore, there is little reason to suggest that home ownership will continue to fall permanently due to affordability.

[5] Unpublished information for England shows that the time profile for mortgage payments as a percentage of income for first-time buyers is very similar, although the level is higher.



Mortgage Interest Payments / Income – Australia and the UK

The difference in affordability movements between the two countries can, however, be reconciled by considering the second factor affecting ownership – **the availability of mortgage credit**, which, at first sight, reveals a paradox. Between 1977 and 2014, the aggregate ratio of mortgage debt to income rose at an annual rate of approximately 5% and 3% in Australia and the UK respectively – this is why central banks worry about housing markets and the effects on macro stability. There is no obvious equilibrium value for the debt-to-income ratio towards which the economies are tending. A widely held view is that house price inflation is directly related to the rapid expansion in mortgage credit; some would even argue that limiting house price inflation requires limitations on aggregate mortgage growth by the central banks[6]. A variation on this theme is the need for controls on loan-to-value and loan-to-income ratios; more on this and the dangers in a minute.

However, although house price inflation and mortgage debt are, undoubtedly, highly correlated, I would suggest that the former causes the latter, not the other way round. Indeed, my own research[7] finds that house price growth in the UK can be explained without reference to credit variables between mortgage deregulation in the early 1980s and the GFC, as theory would suggest. Although credit restrictions in the GFC were certainly important in explaining price falls, more generally households have not faced credit shortages.

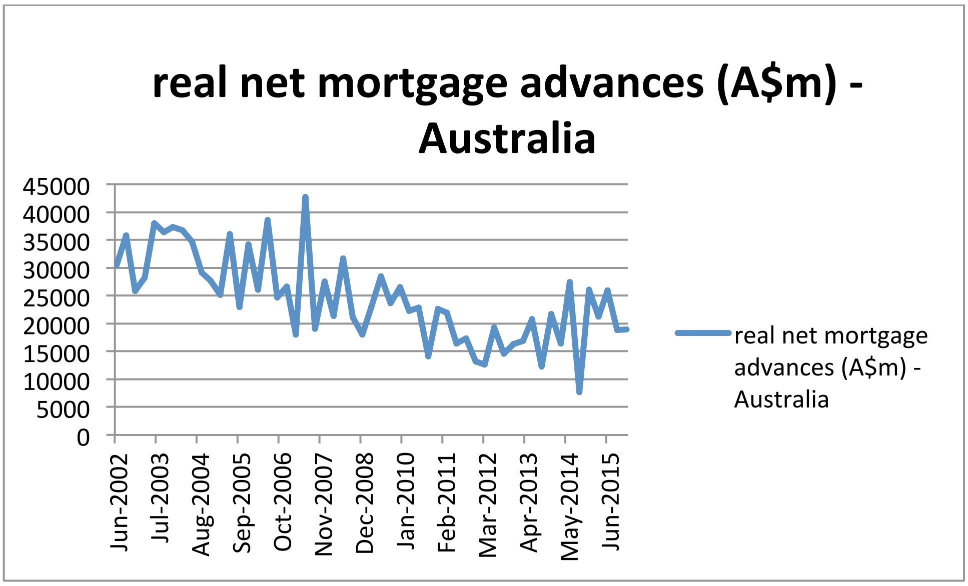
Even if *aggregate* debt to income ratios have risen dramatically, the effect on first-time buyers depends on the *distribution* of debt between existing owners, first-time buyers and

[6] See, for example, Saunders (2016).
[7] See, for example, Meen (2013)

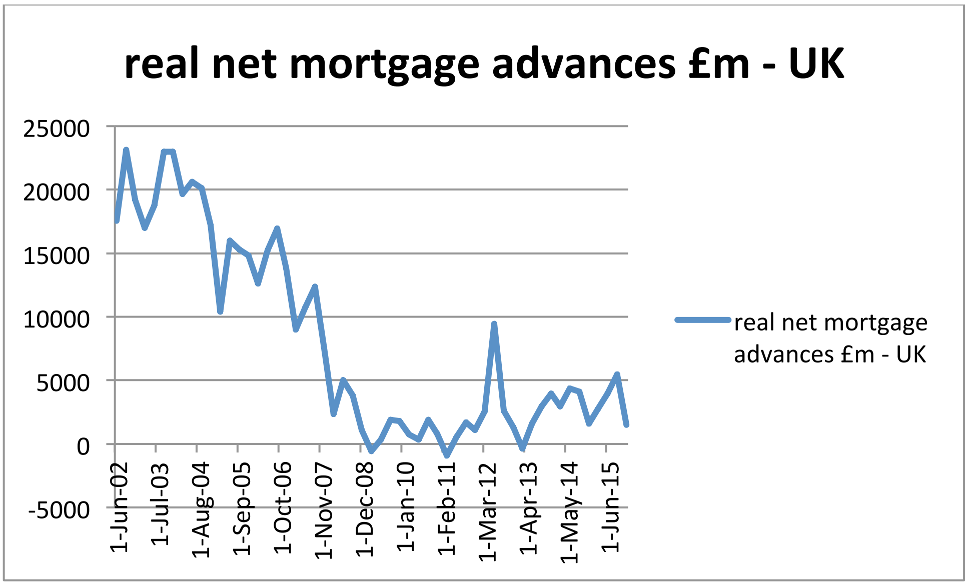
investors and here there are differences between the two countries. This is most clearly seen in the deposit requirements for first-time buyers. The annual cost of owning may have been lower in the UK, but this is of little value to first-time buyers if they do not have access to credit. As examples, in the UK in 2015, the median deposit for first-time buyers was 18% of the property value and only 21% of first-time buyers were able to able obtain loan to values in excess of 90%. Furthermore, in 2015, only approximately 30% of residential advances for house purchase[8] were to first-time buyers, the rest going to existing owners or investors (the Buy-to-Let market).

A further aggregate indicator is that in real terms (deflated by house prices), the volume of net mortgage advances is now at levels similar to the 1970s before the deregulation of mortgage markets. By contrast, although it is slightly more difficult to obtain up-to-date comparable data, it appears to be the case that, generally, deposits paid by first-time buyers in Australia have been rather lower and aggregate real net advances have certainly not fallen to the same extent.

To summarise, whereas housing affordability measured by mortgage payments relative to income have worsened directly in Australia, the constraint in the UK has come primarily from deposit requirements, which predate the GFC. Furthermore, the question arises whether the constraints are permanent or temporary, delaying ownership until potential buyers can save for longer. If the latter is true, then the case for government intervention is reduced since measures simply bring forward ownership rather than having a permanent effect.



[8] This excludes remortgaging by existing owners.



Real Net Mortgage Advances (deflated by house prices) – Australia and UK

Furthermore, there is a policy dilemma between the needs of expanding home ownership and macro stabilisation. Much of current UK housing policy designed to promote home ownership has concerned attempts to mitigate these deposit constraints; Help to Buy schemes, in particular, have been in operation since 2013 and its equity loan scheme allows borrowers to obtain a government equity loan of 20% (now 40% in London) of the value of a newly built property to be supplemented only by a 5% cash deposit and a 75% conventional loan. Although they are forms of demand subsidy, there is little evidence that they have, as yet, added to house price inflation. However, for most areas (there are exceptions in some parts of the country) these initiatives have limited impact on households at the bottom end of the income distribution – rather they help those who might have been traditional home owners under more "normal" housing conditions and are near the cusp of home ownership. Rather like First Home Owner Grants, it is may well be the case that Help to Buy brings forward purchases rather than having a strong permanent long-run impact.

By contrast, the Financial Policy Committee of the Bank of England was granted Powers of Direction in 2015 over loan-to-value and debt-to-income ratios for owner occupied mortgages as part of its macro prudential policy. Furthermore, the 2012 Mortgage Market Review tightened considerably lender assessments of borrower ability to repay loans. Inevitably, these controls are likely to fall mainly on first-time buyers since existing owners have already accumulated sufficient equity in their current homes for the constraints not to be binding. Work by both the Bank of England and the Reserve Bank suggests that the probability of mortgage default is positively related to high loan-to-value ratios, so there is a justification for the actions in terms of the Bank's remit. But central banks have no responsibility for the induced effects on home ownership.

The third factor affecting home ownership rates is the **income distribution**. Briefly, the earnings of the young having been falling relative to older households since at least the 1990s in the UK. This obviously has a direct effect on affordability, but additionally, as discussed later, house prices are determined primarily by the incomes of existing households, who are older. Furthermore, in a downturn the incomes of the young fall more than older households and, hence, they are unable to take advantage of lower house prices.

The final factor relates to the **investment sector,** whose impact remains controversial in both countries. In England the decline in home ownership was compensated by a rise in the private rented sector (as well as a decline in household formation rates for the young), which has now doubled to approximately 20% of households and approaches the Australian share of 25%. Importantly, the PRS is now larger than the social housing sector, and includes low-income households receiving housing benefit. The provision of Buy-to-Let loans to expand the investment market was pivotal. This broadly took place at the same time, in the mid-1990s, as the rapid expansion in the investment market in Australia. In both cases, the expansion occurred as a result of greater competition amongst lenders, the entry of new mortgage originators, the advent of securitisation on a large scale and low returns in equity and bond markets. In the case of Australia, the benefits of the long-standing tax arrangements, notably negative gearing, were enhanced by easier access to finance and falling real interest rates (Productivity Commission 2004 page 92). The share of investment loans in total housing debt rose from 14% in 1990 to current levels of approximately 35%. For comparison, approximately 14% of the UK mortgage stock is Buy to Let Loans; in terms of the share of new house purchase advances, Buy-to-Let loans exceeded those granted to first-time buyers for the first time in the first quarter of 2016; in both countries investment is heavily concentrated on small landlords.

Our research[9] has demonstrated that because of the inbuilt advantages that investors have in access to finance – they are able to reinvest accumulated equity in their existing homes - they add to market volatility. The advantages have led to recent tax changes for residential investors, including reductions in mortgage tax relief and increased rates of stamp duty. But, even if the tax changes are justifiable in terms of offsetting inequalities in access to

[9] See Meen (2013).

credit markets, they also introduce tax non-neutralities between housing and other forms of business investment and between tenures and there are questions whether tax changes are the most appropriate instrument.

However, even if investment adds to volatility, it does not necessarily follow that it permanently contributes to a reduction in ownership. We cannot necessarily conclude that the rapid expansion will continue. In addition to the controls likely to be imposed on the sector by the Bank of England for prudential purposes and the recent tax changes, it is likely that investors, in Australia as well as the UK, are underestimating the true risks of housing investment. Our research[10] shows that the risk premium consists of three elements – the variance of house price movements, the covariance between the return on housing and risky financial assets and the market value of the housing stock. Typically, the variance of house prices has been less than for stock markets and the covariance has been neither consistently positive nor negative, which partly explains why housing remains popular as an investment; but the third element is less-well appreciated and implies that if house prices have been rising, then the market has the inbuilt seeds of its own destruction. This is not dependent on a Global Financial Crisis and holds equally for Australia as the UK and reduces the attractiveness of housing investment, which depends heavily on expected capital gains, since rental yields are typically modest.

In summary, I am not entirely convinced that home ownership rates will continue to fall, although this is rather speculative. But we should not simply assume that because ownership has fallen in recent years, it will inevitably continue to do so – there are a variety of stabilising forces of different strengths. Furthermore, this suggests that the over-concentration of policy on raising ownership rates is misplaced, given that it is not a free good, although the political realities have to be recognised. In passing, we might note that in 2004 the Productivity Commission report into first homeownership (p220) stated:

> " … *the case for providing assistance explicitly directed at increasing home ownership levels is not strong, and that diverting some or all of that assistance into other measures to help low income households may well provide a better return to the community".*

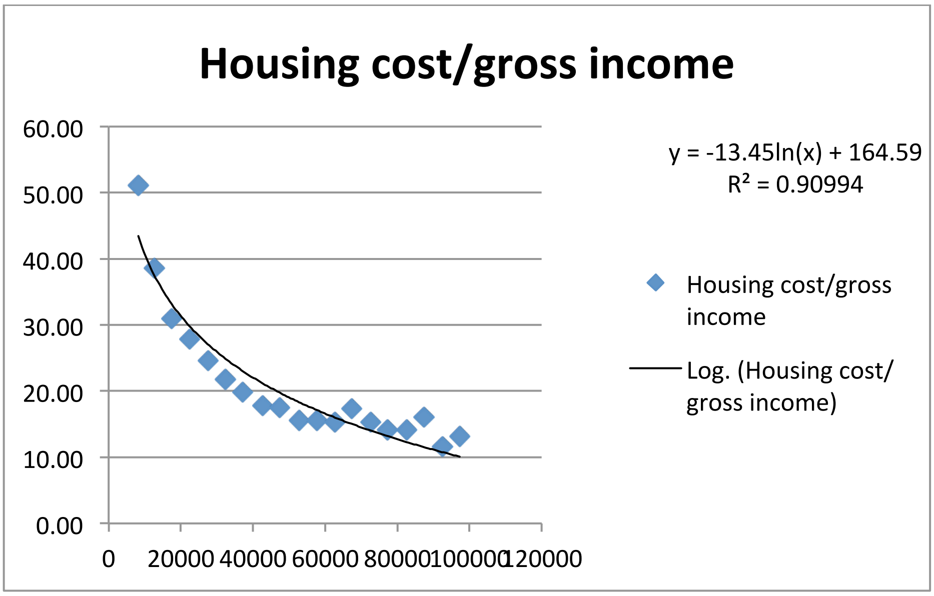
By contrast, I would suggest that the problems of affordable housing for low-income households are permanent and structural and, arguably, more in need of government support. This requires us to look at the distribution of housing costs rather than averages. The graph below shows one measure taken from the English Housing Survey in 2012/13

[10] See Meen at al. (2016).

and 2013/14 and looks at the relationship for households with heads aged between 20 and 45, aggregating over both renters and owners (although costs are higher for renters than owners). On this measure, approximately 30% of households were spending more than 30% of their gross income on housing. Alternatively, in 2013-14, on average, private renters in total spent 43% of their gross household incomes on housing costs, including housing benefits, and 52% excluding benefits.

Using slightly different definitions for Australia, the table below demonstrates a similar point. It shows that, across all tenures in 2013-14, households in the lowest income quintile spent 27% of their income on housing costs, but this falls to 9% for those in the highest quintile. The position is even starker in the PRS, with equivalent figures of 47% and 12%. Furthermore, the percentage of income spent on housing costs for those in the lowest quintile has increased over time.

If, as is commonly the case, we define households to be in stress if they are spending more than 30% of their income on housing (although arguably a higher percentage should be used), then it is clear that not only are households in the lowest quintile excluded from private renting but, increasingly, those in the second quintile (the 30:40 indicator of affordability stress). As Kath Hulse and her team (2015) have shown, in Australia, the problem of rental housing supply is not an absolute shortage, but a shortage of properties available to those at the bottom end of the income distribution.



Owner Occupier and Rental Housing Costs / Gross Income – England

Housing Costs by Income Quintile - Australia, 2013-14

Survey of Income and Housing 2013-14		Owner without a mortgage	Owner with a mortgage	State/territory housing authority	Private landlord	Total renters	All households
Housing costs as a proportion of gross household income							
Lowest quintile	%	8	45	25	47	40	27
Second quintile	%	5	23	19	29	28	18
Third quintile	%	3	20	14	21	21	16
Fourth quintile	%	2	17	13	19	18	14
Highest quintile	%	1	12	9	12	12	9
All households	%	**3**	**16**	**21**	**20**	**20**	**14**

One approach to increasing the supply of affordable housing – and one that is used in the UK, although I would not recommend it – is simply to change the definition of affordable housing. The current definition of an affordable home, set out in the National Planning Policy Framework is:

> "Socially rented, affordable rented and intermediate housing, provided to eligible households whose needs are not met by the market. Eligibility is determined with regard to local incomes and local house prices."

This definition includes some homes for sale as well as rentals and Starter Homes were added in the 2016 Housing and Planning Bill. Two points stand out: first, affordable housing is not defined in relation to income as, for example, occurs in stress measures; second, an increasing share of so-called affordable housing is for home ownership.

Housing Supply and Affordability

3. ***General* increases in housing supply have only a limited effect on affordability unless they are large and sustained and are accompanied by changes in fiscal policy. These are not alternatives.**
4. ***General market* increases in housing supply have only a limited trickle-down effect to affordable housing for low income groups.**

The question now arises whether increasing the market housing supply can have a significant effect on both affordability and affordable housing; the issue is important because this has been the primary policy instrument advocated by both governments. It is clearly attractive to governments, because there are no negative effects on public borrowing; it is all down to the private sector.

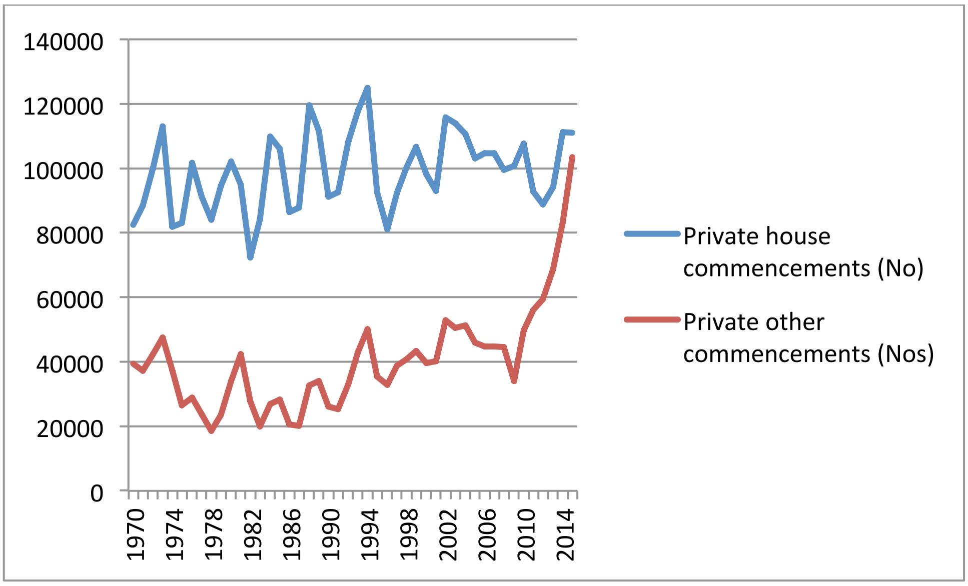
The graphs below show housing completions for the private and social sectors in England and commencements in Australia, disaggregated between private houses and other dwellings and also showing social commencements. From the graphs there are two common features; first, at least in terms of houses (and total construction for the UK), there has been no upward or downward trend since 1970; in fact in England, this has been true since 1920. Therefore, it has been extra-ordinarily difficult to produce permanent increases in the level of housing construction. Large increases have been achieved on a temporary, although sometimes lengthy, basis – usually in response to specific events such as wars, slum clearance programmes or recessions – but never on a permanent basis. Of course, looking at the graphs, this has been less so in the case of apartments, which have clearly expanded considerably in recent years in Australia. The share of apartments has also increased in England, partly due to former legislation which required 60% of new build to be on brown field sites, primarily in towns and cities.

Furthermore, since 1980, the total level of construction in the two countries has been very similar, averaging around 150,000 units per annum; but the population in England is approximately 53 million and only 23 million in Australia and so new building per head has been more than twice as large in Australia. And yet, Australia has, as we have seen, faced similar affordability problems to the UK. Putting this in a slightly different way, the overall housing stock is currently growing at approximately 1.7% per annum in Australia, but at less than half this in England. This plants seeds of doubt whether *general* supply policies, by themselves, can improve affordability – more on this shortly.

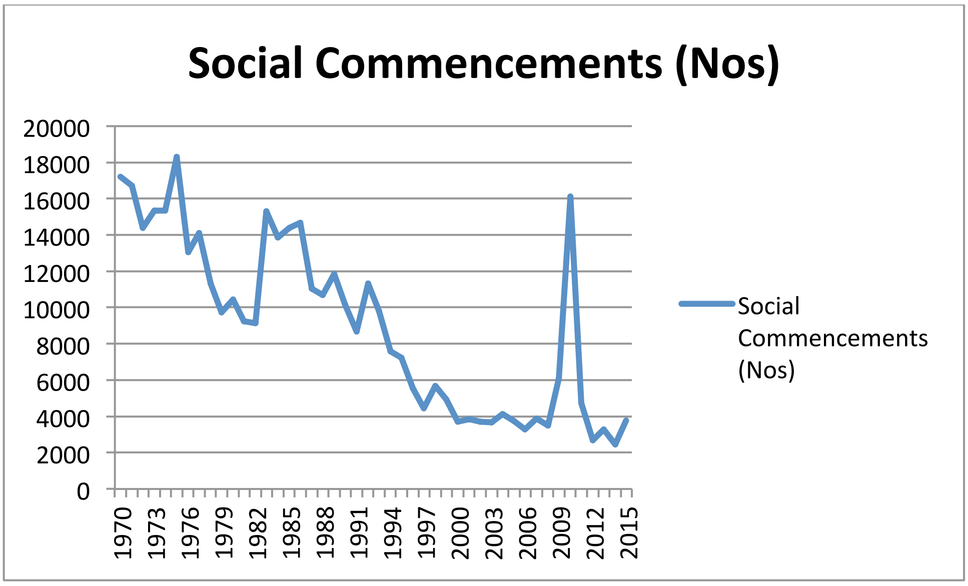
Second, in both countries, social housing has fallen, although the absolute numbers are much smaller in Australia, reflecting the greater reliance on the PRS for low income households. Lucy Groenhart and Terry Burke have recently provided a review of the changing characteristics of public housing in Australia over the last 30 years. In England new social housing now comes primarily from housing associations. With modest exceptions, very little housing is now produced directly by local authorities.

Box 2

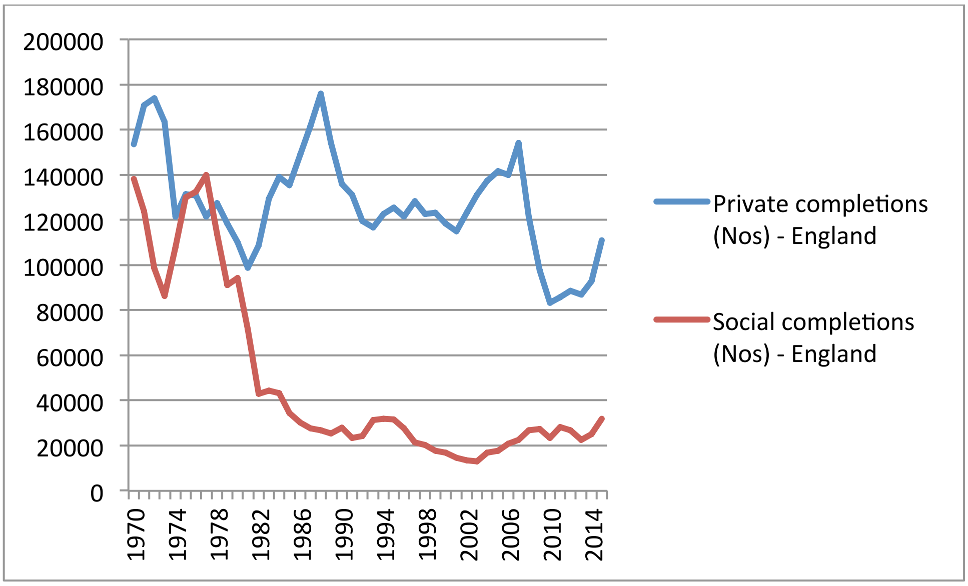
Insufficient housing supply in both countries has attracted considerable attention, but, importantly, in both, the fall has occurred primarily in the public sector. Over long periods of time private construction has exhibited no upward or downward trend, although there has been strong volatility.



Private Commencements (Nos, Australia)



Social Commencements (Nos, Australia)



Private and Social Completions (Nos, England)

We are now in a position to answer the key question – are *general* policies to increase housing supply sufficient to promote radical improvements in affordability? Alternatively, can freely operating private sector markets, backed up by the removal of land-use planning restrictions, be relied upon to produce affordable housing for those towards the lower end of the income distribution? Arguably, reliance on the private sector alone, with induced tickle-down benefits to the lower end of the market, has become the conventional wisdom in both countries. If it works, it is the silver bullet for which housing policy makers have been searching for decades.

However, there were warning signs that things might not be quite this simple some time ago. For example, the 2004 Productivity Commission Report on First Home Ownership stated:

- *Much of this increase in housing demand has been due to cheaper, more accessible finance and buoyant economic growth through the 1990s*
- *This led to higher prices because of the inherent limitations on the responsiveness of housing supply to surges in demand, particularly* ***as much of the demand came from existing home owners seeking to 'upgrade' in established areas****.*

An important element is highlighted in bold and is not always sufficiently appreciated. The report also stated:

".. *the cumulative response to lower finance costs was a growing demand for housing, most of it not from first home buyers*" and "… *in addition to the effects of cheaper and more accessible credit, a sizeable proportion of the burgeoning demand for housing has come from higher incomes and more jobs … in short economic growth*".

and:

This is not to suggest that governments could not make supply more responsive. However to accommodate a general surge in demand, actions would need to be focused on the more desirable suburbs, where higher density development is not feasible on a large scale and, even if successful, would not necessarily meet the preferences of many of those seeking to upgrade.

Although we might possibly disagree over the role of finance, I concur with the overall message: additional factors such as domestic population and immigration growth play a role, but they are not the prime drivers. Furthermore, there is still a widespread view that if we are able to match the number of newly-built homes to the expected rise in the number of newly-forming households, then prices and affordability will stabilise. Under this view of the world, the number of new households is an external force affecting housing requirements, rather than the result or outcome of the behaviour of existing households. In fact, as above, existing households raise their demands for housing as their incomes increase, worsening affordability and a consequence is that household formation rates decline. To stress the point, new household formation is the result of affordability, not a primary driver.

At approximately the same time, the Barker Review in the UK came to the same conclusion; this indicated that bringing the rate of growth of real house prices down to the European average would require an approximate doubling of the level of housing construction. This was well in excess of the rate of household formation. In other words, on a per capita basis, England would have to approach the Australian levels of construction. Subsequently, the National Housing and Planning Advice Unit, using more detailed modelling, broadly confirmed the same result – very large increases in housing supply over extended periods of time are necessary to produce major improvements in affordability, because the demands by existing households for both consumption and investment purposes are strongly responsive to the growth rate of the economy and household incomes.

Furthermore, if price movements are primarily determined by the behaviour of existing owners trading up as the economy grows, it follows that demand-side policies to reduce prices also need to concentrate on current owners[11] rather than potential first-time buyers. Schemes such as First Home Owner Grants or Help to Buy probably have a rather modest impact on prices. However, although fiscal policies can be effective, they are highly unpopular. These include reforms to property taxation, capital gains taxes, inheritance taxes and stamp duty, all of which make considerable sense to an economist, but fall into the "too difficult" category for politicians and who am I to criticise? But, nevertheless, if supply-augmenting policies are to be effective, they need to be accompanied by tax reform; the two are not alternatives.

Neither the Productivity Commission, nor the Barker Review dismissed the role of planning reform – far from it. Both supported the need for reform and saw planning as a major source of delay. Planners and economists have long held differing views on the role of planning. The former stress the ability of planning to increase the supply of affordable homes (inclusionary zoning, planning bonuses in Australia, S106 in UK), whereas the latter represent planning as a constraint on increasing supply. As Andrew Beer (2007) suggests, planners see planning as a reaction to market failure, whereas economists see it as a cause and stress a reduction in controls as a way of increasing supply (with trickle down advantages to low-income households, rather than direct housing provision). However, in practice, planning has rarely been conducted totally independently of markets or wider forces; Kate Barker placed emphasis on market signals in house and land prices as an indicator for land release and current English planning guidance notes the need to "take full account of relevant market and economic signals".

[11] This is sometimes supported as a way of correcting "over-consumption" of housing, where households occupy larger homes than assessed necessary on the basis of need. However the term is highly misleading and simply reflects the market, since the demand for space rises with household incomes, and the fact that the costs of owner-occupied housing are typically low after the early years of a mortgage.

The first major planning controls came into operation in the UK in 1947; however the level of construction in the inter-war period was, on average, no higher than in the post-war era. Therefore, if planning controls did bite it was that they failed to allow construction to respond to the higher level of demand as the economy expanded. However, there is no doubt that, particularly in the south of England, the difference in the price of land with planning permission relative to its agricultural value is enormous, leading Paul Cheshire and Tim Leunig, amongst others, to advocate more radical, market-based, reforms. Paul Cheshire and Steve Sheppard (2005) have proposed that if the difference in the price of land between its current use and the proposed use for development exceeds a threshold, there should be a presumption in favour of development, unless it can be demonstrated that the environmental or amenity benefits of the existing use are sufficiently valuable to society. The proposal has the advantage of transparency and, arguably, would speed up planning processes, but, in practice, is unlikely to be adopted in my view.

Furthermore, it is arguable whether, even if a full presumption in favour of development existed, the increase in supply would be of the required scale noted earlier. At least on the basis of history, a permanent doubling of output seems unlikely; one reason is the business model adopted by builders.

As the 2015 Lyons Review put it:

> *"The speed at which sites are built out is dictated by market demand for the finished houses. Because of the risks of land scarcity, house price volatility and the high upfront capital costs of development, house builder business models are predicated on a high profit margin and double-digit returns on capital (frequently cited at 20% per annum). Most volume house builders work to targets for both sales volumes and return on capital. This means that private new build starts follow the same pattern as overall rate of house sales".*

The causes of slow build out rates and the possible relationship to land banking was a concern of the House of Lords Economic Affairs Select Committee. But a plausible view of slow building or drip feeding[12] is that it is an inevitable consequence of underlying market volatility, where macroeconomic policies do not pay sufficient attention to their impact on housing markets. In an uncertain environment, the rational response may be to delay investment until conditions are clearer. House prices are, at best, difficult to forecast even in the short run. The empirical evidence suggests that, in both countries, housing construction is are very responsive to the *growth* in house prices (but not the *level*) and house price volatility generates an even greater volatility in construction. It follows that

[12] The 2004 Productivity Commission Report on First Home Ownership also acknowledged drip feeding as a feature of the Australian market, but did not see this as caused by land banking behaviour.

macroeconomic policies that contribute to improved house price stability may enhance the level of new building. Furthermore, put at its most basic, it is not always in the interest of builders to increase construction and reduce prices, even if desirable from a wider society perspective. Builders can hardly be expected both to increase output and reduce margins, unless there is some compensating fall in market risk. Furthermore, at least in the UK, output has increasingly been concentrated in the hands of a small number of large builders; the largest eight builders now account for 50% of housing output. Furthermore, the numbers of smaller housebuilders, (defined as building 100 units or fewer a year), peaked in 1988 at around 12,200 firms, but had dropped to around 2,400 by 2014. Although the Global Financial Crisis was a central factor in the recent decline, this continued a longer-run trend towards concentration. By contrast, in Australia, the concentration of market power appears to be more muted and building practices received less attention in the Productivity Commission report, which suggested that the industry was broadly efficient and competitive with scope for new entrants limiting market power.

Box 3

1. **In order to stabilise affordability, the increase in the number of new homes must be greater than the increase in households.**
2. **On the basis of current research, the change in affordability in the long run is determined by the growth in household incomes relative to the growth in the housing stock. In both Australia and the UK, the former usually exceeds the latter. Indeed, as the economy expands, affordability worsens and declining affordability could be seen as a sign of economic success.**
3. **It is most unlikely that private housing increases by themselves will be sufficient to stabilise affordability. This would require major permanent shifts of resources and the model adopted by builders is unlikely to bring this about. Furthermore, they would need to be accompanied by changes in housing taxation to reduce demand.**
4. **It follows that the "trickle down" effects onto affordable housing for low-income households will also be modest.**
5. **Despite the fact that Australia builds, on a per capita basis, more than twice the number of homes as England, there are still similar problems – falling home ownership and insufficient low cost rental homes.**
6. **But this does not imply that the need to increase housing supply should be neglected; rather it is a recognition of the limitations to what general housing supply strategies can achieve alone in terms of improving affordability and access to housing for low-income groups. Instead, supply needs to be one part of an integrated approach, including the factors that affect the demand for housing by existing households and, ideally, a greater recognition of the needs**

of housing in macroeconomic fiscal and monetary policy (although this seems unlikely). Furthermore, it suggests the need for more targeting.

Support for Low-Income Housing

> **5. Funding for low-income housing will not primarily come from government and, therefore, there is a need for innovative funding methods.**

The just-published House of Lords Economic Affairs Select Committee Report into UK housing shortages argued strongly that the private sector alone could not be relied upon to meet the demand (and need) for housing, both for the population as a whole and for low-income groups in particular. Indeed some of the recent policies discussed above are likely to reduce housing supply for low-income households. In both countries, there is little disagreement about the need for more low-income housing; the question is the method of delivery.

I have already argued that the trickle down effects of a general expansion in supply are likely to be modest. The Committee, instead, recommended an increase in direct social provision, both through housing associations and local authorities; the former have built approximately 30,000 homes per annum in recent years and the latter only around 1,000, compared with a peak of approximately 200,000 in the early 1950s. Witnesses to the Committee suggested that housing associations could double their output and there was an appetite for expansion by at least some of the major local authorities. Since social sector homes are largely constructed by the same builders as private properties, there is a concern whether additional public housing would crowd out the private sector, but there is little evidence that this is the case at current low levels of construction, although it could become an issue closer to industry capacity. Furthermore, there are significant advantages to direct provision; first, targeting low-income groups becomes feasible, rather than relying on indirect trickle-down effects; second, social housing is not constrained by market demand in the same way as the private sector – it does not need to drip feed the market and build out rates may be faster. Third, it can be used counter-cyclically to offset reductions in private building in a slump; finally, it can utilise public sector land holdings. In practice, local authorities are subject to limits on borrowing for direct council housing, because it affects the public sector borrowing requirement. Similarly, in Australia, the Council on Federal Financial Relations *Affordable Housing Working Group: Issues Paper* (2016) stresses the need to "take into account the current constrained fiscal environment across the Commonwealth and States and Territories". There seems little prospect, therefore, that further significant housing expansion will come from the public housing directly; the problem is simply too big.

Kath Hulse and her collaborators (2014) set out four types of policies to address the shortage of low-income rental properties, ranging from better targeted rental subsidies to direct provision. It would not be appropriate for me to comment on the success of the range of initiatives that have taken place in recent years including the National Affordable Housing Agreement, the National Rental Affordability Scheme and the Social Housing Initiative; Australia has its own critics of whether these schemes have addressed the full extent of the problem.

However, the strategic direction of social housing has been to facilitate the growth of the not-for-profit sector in providing housing for low to moderate income groups. Social housing in Australia – both public and community - has always, of course, been much smaller in percentage and absolute terms than in the UK. At June 2015, there were 403,767 social housing dwellings of which 321,627 were public housing, 72,105 were community housing and 10,035 were state-owned and managed indigenous housing dwellings (SOMIH). Community housing has expanded considerably in recent years, partly as a result of stock transfers. Yet, despite a target of increasing the share of community housing in total social and affordable housing to 35% by 2014, the sector currently remains modest in size, although the *Working Group* argues that "Large growth-orientated community housing organisations may have the potential to become substantive players in the provision of large-scale affordable housing solutions". But this means the expansion in access to private finance.

Social Housing Dwellings

Year @ 30th June	Public Housing	Community	SOMIH	Total
2007	339,771	34,707	13,098	387,576
2009	336,464	42,384	12,056	390,904
2011	331,371	59,777	9,820	400,968
2013	328,340	65,865	10,084	404,289
2015	321,627	72,105	10,035	403,767

Source: the Council on Federal Financial Relations *Affordable Housing Working Group: Issues Paper* (2016)

Judy Yates (2013) identifies two constraints on expansion: first, whether community providers will have the financial capacity without further government support; second, whether they will have sufficient access to private sector funds to finance expansion. The sector is not yet considered sufficiently mature to attract large-scale funding from private institutions on favourable terms. Concerns have been expressed whether the returns to the private sector will be sufficiently high, whether the risks are too great and, as relatively new entities, the absence of a track record will require a substantial risk premium or the provision of government guarantees or subsidy.[13]

By contrast, although I would not want to suggest that all has been smooth, housing associations in the UK provide a relatively low-risk investment, with fairly safe rental revenue streams, which until last year were backed by a government promise to enable increases in rents at above the rate of inflation and to maintain housing benefit for social tenants accepting the rents set by associations. UK housing associations have increasingly relied on private finance, either through bank borrowing or bond issues, because of ever decreasing amounts of public subsidy for rental housing. In the Australian case, I understand that the *Working Group* is consulting on alternative funding models, including, for example the scope for Housing Supply Bonds as advocated by Julie Lawson and her team (2012). However, whatever model is adopted, it has become clear in both countries that innovative housing finance solutions are central. The money will not come directly from government. Even local authorities in England have become inventive in developing new models, including local authority owned companies managed at arms' length, partnerships with housing associations, joint ventures with private developers, and the investment of local authority pension funds in house building for private sale.

[13] Berry (2003) provides an earlier discussion of alternative models to attract private finance for affordable housing including bond issues.

In Conclusion

In conclusion, there is no single silver policy bullet for improving affordability and affordable housing, remembering that most long-run improvements to housing conditions have not primarily been as a result of direct housing policies. We could imagine a world of economic theory in which:

- All planning regulations are abolished or at least there is a presumption in favour of development except in areas of high environmental quality,
- Major reform takes place with respect to housing taxation so that the system is neutral across tenures and asset classes,
- The construction industry is highly competitive, there are no skills or finance shortages and the industry is innovative and highly productive,
- There is little housing market volatility so that the risk premium required by builders is lower,
- Monetary policy takes greater account of housing conditions,
- There is a more equal income distribution.

Under these conditions, there would probably be little need for social housing provision, because private markets would cater for all segments. But we do not live in this world; the essence of housing economics is that it needs to take account of market failures, frictions and non-neutralities. As I noted at the start, modern policy is constrained by the institutional structure built up over the last hundred years or more and history tells us that rapid change rarely occurs. Therefore, the need for social housing will remain in both countries as a long-run structural feature, although we need to be realistic about what housing policy alone can achieve. It always has been the case that housing is the poor relation of wider macroeconomic objectives.

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