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Housing affordability – the deposit gap

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Summary

Housing affordability forms part of the ALP's justification for changing 70 years of taxation law and outlawing negative gearing on all investments apart from new housing.

Most analysis has concentrated on the cost of negative gearing to the budget, and the amount of money that might be raised. Virtually no analysis has been done of whether it is a sensible way to tackle housing affordability.

This analysis shows the major issue with housing affordability is the time it takes to save a deposit, and that mortgage repayments themselves are quite affordable by the standards of the last 23 years.

We demonstrate that once a home owner buys a house the difficulties they face are no different to those of the previous generation, and so, if it were thought desirable to increase the rate of home ownership, policies directed towards shortening the time it takes to save a deposit, would be preferred to abolishing negative gearing.

Saving the equivalent of 10% of before-tax earnings on the average income it would take 12.2 years to save a 20% deposit to purchase the median house in Brisbane, or 23.8 years in Sydney. To reduce that by, say, say, 2 years in Brisbane, negative gearing would need to reduce house prices by approximately 20%.

This would create economic turmoil, and most likely throw the economy into recession, given the blow to confidence that a decrease in house prices of this level would produce.

As rent and repayments for equivalent houses are not significantly different, alternative policies bridging the deposit gap should be the preferred way to improve housing affordability rather than a change to longstanding taxation policy that would have negative, and difficult to quantify, confidence effects on the housing market and the economy.

This analysis does not look at other issues which affect housing affordability, such as supply and high immigration rates. While getting these right would also make houses more affordable by gradually lowering real prices, that would involve state and local governments altering taxation and planning laws and procedures. It would take some time to happen, if it happened at all.

The paper suggests a number of mechanisms for helping first home buyers with the deposit.

1. A first home buyer deposit gap scheme funded by the government
2. Giving first home buyers access to their superannuation funds for the purposes of buying their first home
3. Encouraging financiers to offer deposit bridging finance
4. Encouraging parents or other relatives to co-invest with first home buyers

We conclude that government's best policy option would be access to superannuation funds. Other options could be explored by participants in the housing industry, and a housing summit might help to incubate innovative ideas.

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Executive Director
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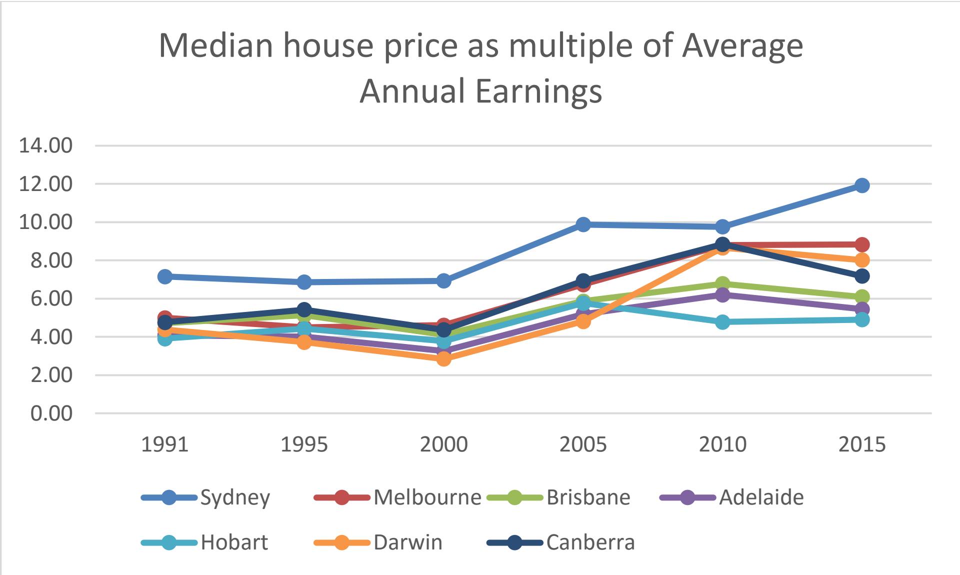
Deposit or repayments

It is claimed that Australia has a problem of housing affordability. Studies conducted by bodies such as the Australian Housing and Urban Research Unit support the contention that since 1996 around 30% of Australian renters have had housing costs above 30 per cent of their income, while home owners in the same position have represented somewhere around 20% of the population since 1990, but with a dip in the mid-nineties[1].

We approach the issue of housing affordability by expressing costs as a percentage of average annual earnings. This allows us to look at housing costs as the average Australian might, and allows a consistent assessment of costs across time by measuring it against actual earnings.

We could have used constant dollars to adjust costs, but items like housing tend to rise at the same rate as growth in GDP, which is generally higher than inflation, so constant dollars would overstate increases in housing costs.

The table below shows the price of the median house in unadjusted dollars as a multiple of Average Annual Earnings[2].



This would appear to show housing becoming increasingly unaffordable. measured on this basis house prices have increased as per the table to

City	Increase between 1991 and 2015
Sydney	67%
Melbourne	77%
Brisbane	29%
Adelaide	33%
Hobart	25%
Darwin	83%
Canberra	51%

[1] http://www.ahuri.edu.au/__data/assets/pdf_file/0011/2153/AHURI_Final_Report_No244_Factors-shaping-the-dynamics-of-housing-affordability-in-Australia-2001-11.pdf?utm_source=website&utm_medium=report.PDF&utm_campaign=http://www.ahuri.edu.au/research/final-reports/244

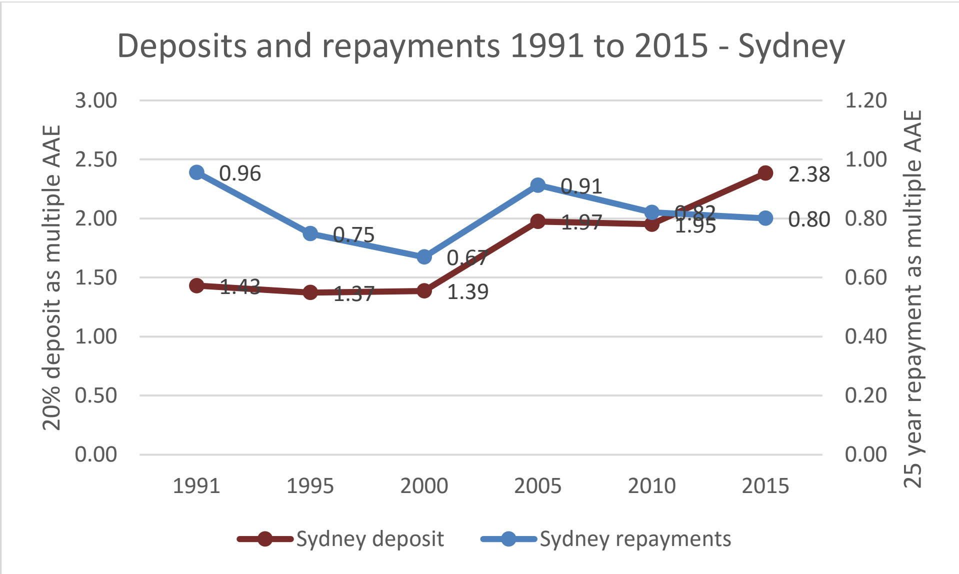
[2] Source: ABS

the right. Measures like that used by Demographia in their International Housing Affordability survey[3] would show this as a housing bubble.

However, people do not buy houses with cash. They use a mixture of debt and equity, and the price of the house is closely related to their ability to fund each. From a servicing point of view, a house which doubles in price may cost the same to pay off as a house at the original value if interest rates have dropped by more than half in the meantime. This is why asset values tend to have an inverse relationship to interest rates. As rates fall, asset values tend to increase.

The graphs below track notional deposits, and house repayments, over 25 years at historically prevailing interest rates for each of the mainland state capital cities excluding Perth. We have allowed a generous deposit of 20%, and used the RBA cash rate plus 2.5% to represent retail interest rates[4].

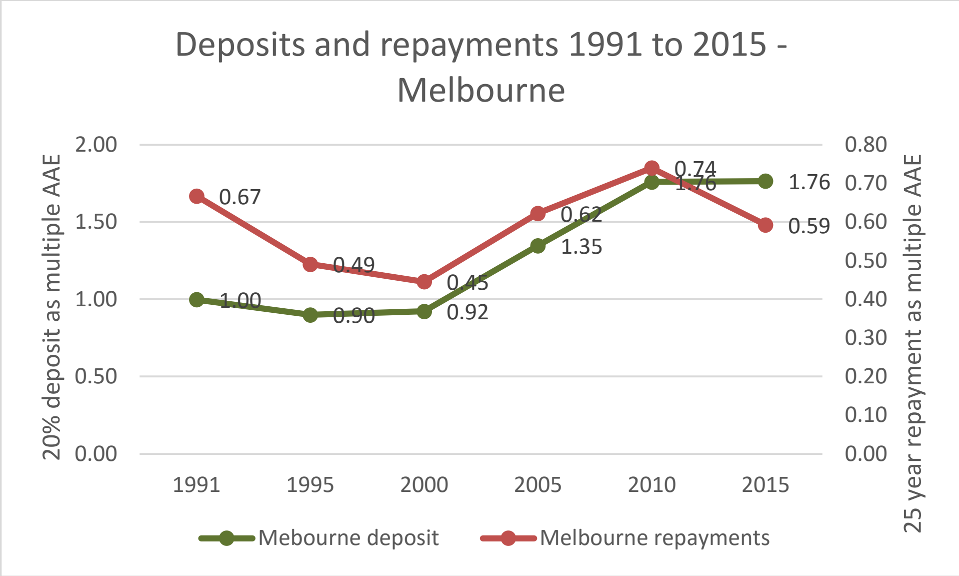
They reflect the real experience of home buyers, rather than the increase in capital values. In theory, values are limited to what a purchaser can finance, and so cannot rise for long past that point. So, unless buyers are irrational, house prices will tend to find equilibrium around a point that can be afforded. Equilibria may be different in different societies, but they will tend to maintain themselves.



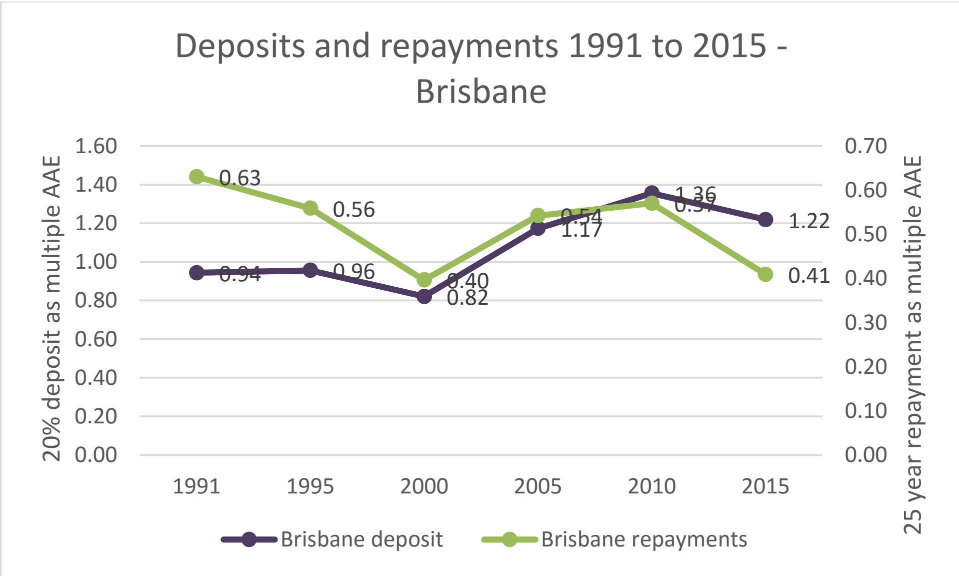
In Sydney repayments over 25 years are almost 16% more affordable than they were 25 years before, but the deposit is 67% less affordable. If you saved 10% of your after tax income in Sydney each year it would take you 23.8 years to accumulate a 20% deposit.

[3] www.demographia.com/dhi.pdf

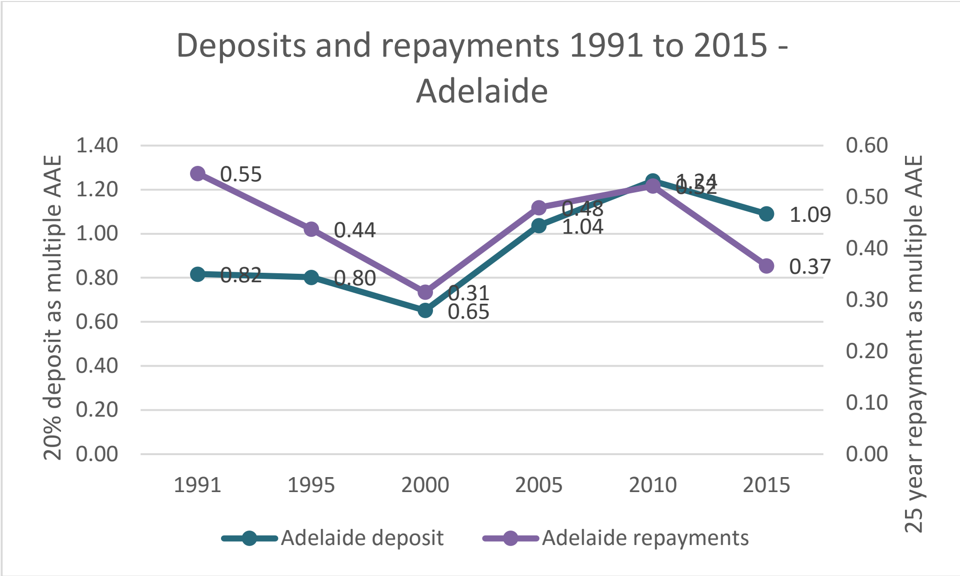
[4] http://www.rba.gov.au/statistics/cash-rate/



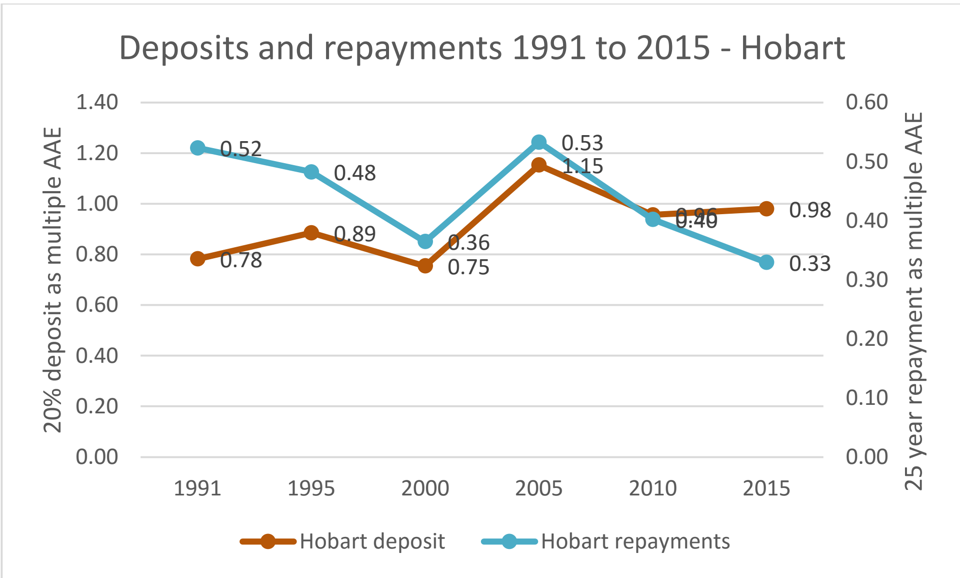
Repayments in Melbourne are also 11% more affordable now than 25 years ago, although there were much more affordable 15 years ago, but the deposit is less affordable by 17%, and would take 17.6 years to save at 10% of pre-tax average income.



Brisbane is one of the most affordable cities. Repayments are 35% cheaper and deposits are only 29% more expensive. It would take 12.2 years in Brisbane to save a 20% deposit at 10% of AAE.



Adelaide is also more affordable on the basis of repayments, with an increase in affordability of 33% for repayments, and a decrease in affordability of deposit of 33%. It would take just under 11 years to save a 20% deposit at 10% of AAE.



Hobart is easily the most affordable with an increase in affordability of repayments of 37% and a drop in affordability of deposits of only 25%. A 20% deposit takes only 10 years to save in Tasmania at 10% of pre-tax average weekly earnings.

So each of these graphs shows two peaks of unaffordability of repayments over 25 years. One as Australia came off the high interest rates of the 80s and 90s, and the other in the period between 2000 and 2010 when house prices surged at different times in different states. Then affordability has increased as house price increase has stabilised and interest rates have continued to decline.

A similar pattern of peaks and troughs has occurred for deposits, but as deposits track house prices only and are unaffected by interest rates, the slope is upwards, resulting in record unaffordability of deposits with an increase of between 25% (Hobart) to 77% (Melbourne) the time taken on average annual earnings to save a 20% deposit on the median house now sitting at 23.8 years in Sydney.

From this analysis it is obvious that what makes housing less affordable in Australia today than it has been is the difficulty taken in raising a deposit.

Solutions

1. Decreasing the price of housing

There is a very good case for decreasing the price of housing. In the 70s and 80s with high inflation and high interest rates this occurred by the price of housing staying stationary for a period of time while the CPI rose quickly. Nominal values held up while real values declined.

This had the advantage of maintaining loan ratios for lenders, thus avoiding forced sales, while occupancy costs reduced rapidly in real terms. Consumer confidence which is affected by the wealth effect, therefore stayed reasonably high.

The ALP negative gearing policy proposes to reduce house prices in real terms (although this is somewhat confusingly also simultaneously denied by public spokespeople).

APRA rationing of lending to the housing investment sector has also had the effect of moderating house price rises with recent rises being marginally negative in many cities[5].

At the same time, particularly in Brisbane and Melbourne, there are expectations of price falls in the high-rise unit market which is generally viewed as being very over-supplied[6]. However it is difficult to quantify what effect this might have on the detached housing market, and housing markets further away from the CBD.

But how much of a decline would be required to take deposit affordability back to say 1991? The answer is that it would take somewhere between a 25% (Hobart) and 77% (Sydney) fall in house prices to achieve this. It doesn't take sophisticated economic modelling to accept this would be very difficult for the economy.

And how could such a fall be engineered? Such a fall is certainly outside the credible estimates of what the ALP negative gearing policy could achieve. For example research by consultancy SQM Research, as quoted in the Australian Financial Review[7] puts decreases in values at between 4% and 15%.

To take their worst case scenario, that would have a negligible effect on the decrease in affordability of deposits in Sydney or Melbourne, although it would significantly help the markets of Brisbane and Hobart.

The best way would be a gradual increase in housing supply, but this would be hard to engineer as planning is decentralised through state and local government authorities. Inasmuch as it would involve mild over-supply, it would also require bankers and developers to act against their own short-term interests.

In countries where property prices have dropped recently, such as the USA, the decrease has been a product of a bust in financial markets, followed by stagnation in the general economy, and devastation in local economies, such

[5] http://www.abs.gov.au/ausstats/abs@.nsf/mf/6416.0

[6] http://www.news.com.au/finance/real-estate/buying/boom-to-bust-how-many-is-too-many-apartments-for-our-big-cities/news-story/8c15498749e077b97bb3aeee16e67e6d

[7] http://www.afr.com/real-estate/residential/house-prices-to-fall-up-to-15pc-under-labors-negative-gearing-plan-sqm-warn-20160621-gpnxf6

as say Michigan, where manufacturing industry has suffered very heavily. No Australian government would want such carnage here, even if it made housing more affordable.

To sum up, negative gearing is unlikely to make a significant difference to the root cause of unaffordability, which is the deposit gap, and if it did, the effects on the economy would be likely to be catastrophic. The other method – to increase supply – is difficult to engineer, and generally results from a boom which is followed by an economic bust, and as such is not desirable.

2. Government funded deposit gap scheme

There have been a variety of schemes to bridge the gap for first home buyers at both a federal and state level since 1964[8]. For example the Queensland government will currently provide a grant to buyers of first homes up to $750,000 of $20,000[9].

These schemes can be criticised on a variety of levels. One is that in theory they should increase the price of a house by the amount of a grant, so it makes the house less affordable for the purchaser, and less affordable for purchasers of second and later properties. While this is true, as most of the price of a house is financed, and it is the ability to raise the equity for a house in the first place, and then service the loan in the second, that matters to the purchaser, there is still a lot of use in these types of grants.

So a purchaser of a median house in Brisbane will pay $475,000, and at 20% require a $95,000 deposit. If they have saved $75,000 plus transaction costs the $20,000 deposit would seem to put them within reach of purchasing a house. However, it is likely that over time the $20,000 will get added to the value of the house. This means that the effective value to them of the grant is actually 80% of its amount, and their interest costs will rise by 3% (note this is not percentage points but percent) as a result.

Current house price	$475,000.00	Price of a median house in Brisbane in 2015
Savings	$75,000.00	Notional savings
Grant	$20,000.00	Maximum Qld First Home Owners Grant
Deposit	$95,000.00	20% of 475,000
Adjusted asset value	$495,000.00	Increased median price if market rises by full amount of the subsidy
Deposit	$99,000.00	Deposit required after market absorbs effect of the subsidy
Additional deposit required	$4,000.00	Additional savings required to purchase median house after maximum possible rise due to subsidy
Effective value of subsidy to purchaser	$16,000.00	Subsidy less the additional savings required
Effective increase of interest rate	3%	Increase in borrowings because of increase in price as a percentage of the original mortgage required

[8] http://www.smh.com.au/business/billions-in-handouts-but-nothing-gained-20110315-1bvvs.html

[9] https://firsthomeowners.initiatives.qld.gov.au/

So only a portion of the grant is actually wasted, although the increase in properties will affect people who are buying a second home, but also give a windfall to those who already own a home.

The more serious criticism of this grant is that it is a direct, and very expensive transfer, to first home owners. The state will take quite some time to recoup this from taxes paid by the recipient of their largesse.

Another criticism is that the market gap could be filled by private enterprise (and in fact has in the past), and that a better way of approaching the problem might be via various forms of commercial lending to bridge the gap, or mortgage insurance. The government action therefore costs the government money for a private good, and crowds out a potential solution which would cost the ratepayer nothing.

3. Government funded top-up loans scheme

Instead of making a grant to a first home buyer the government could provide the money by way of a loan. The analysis of this is similar to the government grant in point 2, except that it takes away the problem of the government providing a private benefit using public money. It would also make servicing the loan more expensive, as unless the government top-up was at non-commercial rates, it would, in the example of a Brisbane house with a 20% deposit increase interest costs by 15%.

A scheme like this could be administered by the government using financial institutions by providing them with a guarantee and allowing them to provide the deposit from their funding sources. This would overcome the crowding out argument and be very cost effective.

4. Allowing first home buyers to access their superannuation funds

This solution has been suggested by a number of sources, including former treasurer Joe Hockey. It would seem to have a lot of merit. Superannuation is a forced savings of 9% of income. If a potential home-buyer was capable of saving, say, 10% per annum of their before-tax income towards a house, allowing them to top up their deposit from their superannuation assuming that they meet certain criteria could double their savings rate, more or less halving the time that it takes to save a deposit (ignoring management fees etc. in the superannuation fund). In the case of Brisbane that would mean that a person on average earnings could save a deposit in just over 6 years. A couple on average earnings would manage it in 3 years.

The main objection to this is that superannuation is about retirement funding. However, this overlooks the fact that superannuation is not the only determinant of well-being in retirement, and in fact the biggest indicator of poverty in old age is not owning a house. If a rational citizen was not able to save enough to buy a house during most of their working lifetime, it would make a lot of sense for them to take a lump sum from their superannuation at the end of their working life and buy a house.

Giving them access to their superannuation as a home deposit is actually more likely to guarantee that they will have a substantial superannuation nest egg when they retire, than shutting them out of the housing market while they work and forcing them to buy a house out of their retirement savings would.

It would probably also boost investment returns. While there is debate about whether the share market or property is a better long term investment, the debate generally proceeds by looking at ungeared returns from these asset classes. If you take financial engineering into account it is going to be difficult for most superannuation funds to match the return from residential housing to the owner-occupier.

If an asset geared to 80% increases in value by 4% p.a. the return on the deposit is actually 5 times that, or 20%. At the same time, interest payments will equate closely to what rental payment would have cost, but they are fixed to the interest rate, and over time generally decrease in real terms, while rent normally increases in real terms.

Giving first home purchasers access to their super, under certain conditions, to buy a house, and possibly spreading the net wider to capture people who do not own a residence, for whatever reason, is our preferred way of dealing with the deposit gap affordability problem.

5. Encouraging financiers to offer bridging finance

At various times financiers have been prepared to offer virtually 100% finance to purchasers. The willingness of financiers to do this will be based on judgements about the economy, the applicant, and the chances of asset appreciation.

APRA is currently discouraging financiers from advancing as high a percentage of the purchase price of housing as they were. This means that only non-conventional lenders could potentially fill this role, and they could also be frustrated further by APRA tightening controls on banks, who would have to be the primary lenders.

There is probably some room for innovation here, but it will occur without government intervention or encouragement.

6. Intergenerational transfer

The main beneficiaries of the appreciation in houses have been home owners, many of whom are the parents, or relatives, of young people unable to enter the housing market because of the deposit gap. Assets have risen in value so quickly that many are sitting on substantial equity which is providing little benefit to the economy, unless it is leveraged into other investments, which most aren’t.

One solution to the deposit gap problem would be to encourage them to provide capital by way of additional mortgage security to their children or relatives. While this would be mostly an issue for individuals and lending institutions, the government could play a role in helping to develop guidelines and even standard documentation to make the process easier.

The transfer does not have to be a subsidy. It could be a fully interest-bearing loan, or even a share of equity in the house being purchased.

Conclusion

The problem with housing affordability that can most easily be tackled without disrupting the economy is the deposit gap. The cost of repaying a loan appears to be well within the boundaries of historical norms, so once a purchaser is into their own home they have no more than average historical difficulty repaying the loan.

Abolishing negative gearing will do little to fix housing affordability, apart from disrupting the housing market and lowering house prices in the short term.

While government schemes to provide subsidies to bridge this gap are currently available they are expensive, and provide a private good at a cost to the general public.

The best solution would be to give potential purchasers access to their superannuation at an early stage to purchase a house. Another solution would be to encourage relatives to provide security or cash to bridge the deposit gap, which could be provided in return for a range of benefits from the concessional to the fully commercial. A third solution would be for commercial institutions to provide funds to bridge the gap. And a last solution a government scheme to provide deposit gap funds via lending institutions.

These would be much preferable to abolishing negative gearing, which we believe ought to be retained as it supports the rental market. Given the long time taken to save a deposit it is important that there is adequate rental housing available.

There appears to be a need to address the housing affordability issue, and we call on the incoming government, whoever they are, to consider the problem of housing affordability as a distinct issue from maximising their taxation revenue in the short term by abolishing measures like tax deductibility of negative gearing against current income.

This could be done via a summit.